



# Legislative Audit Division

State of Montana

Report to the Legislature

December 2004

## Financial-Compliance Audit For the Two Fiscal Years Ended June 30, 2004

### Board of Investments

Department of Commerce

We performed a financial-compliance audit of the Board of Investments for the two fiscal years ended June 30, 2004. This report contains the audited financial statements and accompanying notes for the two fiscal years 2003-04 and 2002-03. We issued unqualified opinions on the financial statements of the Board of Investments' Retirement Funds Bond Pool, Trust Funds Bond Pool, Short Term Investment Pool, Montana Domestic Equity Pool, Montana International Equity Pool, Montana Private Equity Pool, All Other Funds, and Enterprise Fund.

This report contains two recommendations relating to:

- ▶ Timely Financial Reporting
- ▶ Required Rural and Special Improvement District Bond Report

This report also contains a disclosure issue discussing concerns that certain recent INTERCAP loans to state agencies may constitute state debt.

Direct comments/inquiries to:  
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Helena MT 59620-1705

04-03

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## **FINANCIAL-COMPLIANCE AUDITS**

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2005, will be issued by March 31, 2006. The Single Audit Report for the two fiscal years ended June 30, 2003, was issued on March 23, 2004. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator  
Office of Budget and Program Planning  
State Capitol  
Helena MT 59620  
Phone (406) 444-3616

Legislative Audit Division  
Room 160, State Capitol  
PO Box 201705  
Helena MT 59620-1705

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# LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



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Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

December 2004

The Legislative Audit Committee  
of the Montana State Legislature:

This is our financial-compliance audit report on the Board of Investments (board) for the two fiscal years ended June 30, 2004. This report contains unqualified Independent Auditor's Reports for each of the following eight sets of financial statements of the Board of Investments. The Independent Auditor's Reports cover two fiscal years because the board presents two fiscal years in the financial statements for comparative purposes.

- Retirement Funds Bond Pool
- Trust Funds Bond Pool
- Short Term Investment Pool
- Montana Domestic Equity Pool
- Montana International Equity Pool
- Montana Private Equity Pool
- All Other Funds, and
- Enterprise Fund.

The prior financial-compliance audit report, issued for the two fiscal years ended June 30, 2002, contained two recommendations to the board. During our financial audit for the fiscal year ended June 30, 2003, we determined the board implemented these recommendations. This report contains two recommendations to the board. The board's response to this report is at the end of the report.

We thank the members of the Board of Investments and their staff for their cooperation and assistance during the audit.

Respectfully submitted,

*(Signature on File)*

Scott A. Seacat  
Legislative Auditor

# **Legislative Audit Division**

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## **Financial-Compliance Audit**

**For the Two Fiscal Years Ended June 30, 2004**

## **Board of Investments**

**Department of Commerce**

Members of the audit staff involved in this audit were Pearl M. Allen, Hollie Koehler, Jim Manning, Vickie Rauser, and Jeff Tamblyn.

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## **Appointed and Administrative Officials**

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<b>Board of Investments</b>			<u>Term</u>
			<u>Expires</u>
	Richard Anderson, Chairman	Helena	1/2005
	Terry Moore	Billings	1/2007
	Dennis Beams	Kalispell	1/2005
	Karen Fagg	Billings	1/2007
	Maureen Fleming	Missoula	1/2007
	Jay Klawon	Hamilton	1/2005
	Joel T. Long	Billings	1/2005
	Tim Ryan	Bozeman	1/2005
	Calvin Wilson	Busby	1/2007
<b>Administrative Officials</b>	Carroll South	Executive Director	
	Bob Bugni	Interim Chief Investment Officer	
	Gayle L. Moon	Accounting Fiscal Manager	

For further information on the Montana Board of Investments  
contact Carroll South, Executive Director, at:

PO Box 200126  
Helena MT 59620-0126  
(406) 444-0001

e-mail: [csouth@state.mt.us](mailto:csouth@state.mt.us)

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### Board of Investments

This financial-compliance audit report documents the results of our audit of the Board of Investments (board) for the two fiscal years ended June 30, 2004. We issued unqualified opinions on the eight sets of statements contained in this report. This report contains two recommendations for improving timeliness of financial reporting and compliance with state law by the board. It also contains a disclosure issue, beginning on page 7, which discusses concerns that certain recent INTERCAP loans to state agencies may constitute state debt.

The prior financial-compliance audit report for the two fiscal years ended June 30, 2002, contained two recommendations that have been implemented.

The listing below serves as a means of summarizing the recommendations contained in the report, the board's response thereto, and a reference to the supporting comments.

#### Recommendation #1

We recommend the Board of Investments:

- A. Publish its annual financial report by December 31, as required by state law.

Board Response: Concur. See page C-3.

- B. Provide timely draft financial statements to the Department of Administration as required by state policy.

Board Response: Concur. See page C-3.

- C. Consider adopting industry standards for the completion and release of the annual audited financial statements..... 4

Board Response: Do not concur. See page C-3.

#### Recommendation #2

We recommend the Board of Investments review its participation in issuing rural and special improvement district bonds and provide the report required by state law to the next legislature. .... 5

Board Response: Concur. See page C-4.

# Introduction

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## Introduction

The 42<sup>nd</sup> Legislature of the state of Montana created the Board of Investments (board) in 1971. The board has the sole authority to invest all state funds. Funds are to be invested under the prudent expert principle. This principle, as defined in section 17-6-201, MCA, requires the board to:

- (a) discharge the duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;
- (b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so; and
- (c) discharge the duties solely in the interest of and for the benefit of the funds forming the unified investment program.

The investment activity shown on the board's financial statements is also reflected on the accounting records of each individual state agency, county, or retirement system participating in the unified investment program. Board staff is responsible for recording the investment activity on the state's accounting records.

The board has chosen to divide the investment activity into six separate pools. These pools each have a different investment goal and investment policy. Participants invest in the pools by purchasing investment units. The investment pools operate similar to mutual funds.

The board also administers an Enterprise Fund and All Other Funds. The Enterprise Fund is commonly referred to as the economic development fund and contains activity related to economic development bonds and INTERCAP loan activity. All Other Funds includes financial activity related to buildings held as investments, fixed securities, commercial loans, and mortgages purchased from Montana lenders.



## **Introduction**

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### **Audit Objectives**

We performed a financial-compliance audit of the Board of Investments for the two fiscal years ended June 30, 2004. The objectives of our audit were to:

1. Determine if the board complied with applicable state and federal laws and regulations.
2. Make recommendations for improvements in the management and internal controls of the board.
3. Determine the implementation status of prior audit recommendations.
4. Determine if the board's financial statements present fairly the financial position and results of its operations for each of the two fiscal years ended June 30, 2004.

In accordance with section 5-13-307, MCA, we analyzed and disclosed the costs, if significant, of implementing recommendations contained in this report. Issues deemed not to have significant effect on board operations have been discussed with management but are not included in this report.

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### **Prior Audit Recommendations**

The prior financial-compliance audit report for the two fiscal years ended June 30, 2002, contained two recommendations. During our financial audit for the fiscal year ended June 30, 2003, we determined both recommendations were implemented.

# Findings and Recommendations

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## Timely Financial Reporting

**The Board of Investments did not publish its annual financial report for fiscal year 2002-03 by December 31, 2003, as required by state law, and did not prepare four of its eight draft financial statements for fiscal year 2003-04 by September 30, 2004, as required by state policy.**

Article VIII, section 13 of the Montana Constitution requires the investment program be audited at least annually. Under its authority in state law, the Department of Administration issued Management Memo 2-04-11, which established a September 30, 2004, deadline for submitting draft financial statements to the department for use in preparing the state's Basic Financial Statements. Board staff completed preparation of four of the board's draft financial statements for fiscal year 2003-04 by September 14, 2004, two on October 8, 2004, one on October 15, 2004, and one on October 20, 2004.

Section 17-5-1650, MCA, requires the Board of Investments to publish a financial report by December 31 of each year. Other statutes also require the board to prepare an annual report, but do not specify a due date. Board staff did not send the board's annual report for fiscal year 2002-03 to print until at least January 12, 2004.

Industry practice for investment organizations, such as the Board of Investments, in the private sector, as set by federal regulations implementing the Investment Company Act of 1940, provides statements should be prepared and released within 60 days of the end of the reporting period. By reporting within 60 days, the board would provide information that could be used by customers in making decisions. Portfolio disclosures would be current enough to include securities still held by the investment pools. In addition, the audited financial information would be available for use in the budget process and for preparing various other annual financial reports required by state law, such as those for the retirement boards and Montana State Fund.

## Findings and Recommendations

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Board personnel attributed the untimely reporting to staff turnover, and other work priorities. We observed that board staff have increased their use of linked spreadsheets and have allocated report preparation duties out more among staff to facilitate more timely financial statement preparation. Board staff should continue to find ways to prepare and publish annual financial reports in a timely manner, as required by state law and policy, and investment company guidelines.

### **Recommendation #1**

**We recommend the Board of Investments:**

- A. Publish its annual financial report by December 31, as required by state law.**
- B. Provide timely draft financial statements to the Department of Administration as required by state policy.**
- C. Consider adopting industry standards for the completion and release of the annual audited financial statements.**

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### **Required Bond Review and Report**

**The Board of Investments did not conduct a review of its participation in issuing rural improvement district bonds and special improvement district bonds and provide a report to the 58th legislature, as required by Chapter 162, Section 11, Laws of 2001.**

Chapter 162, Section 11, Laws of 2001, required the Board of Investments to provide recommendations to increase or decrease the limit under which a marketability opinion is necessary for rural improvement district bonds and special improvement district bonds issued under sections 7-12-2171 and 7-12-4203, MCA. Currently, these sections allow variable rate bonds to be sold at a private negotiated sale if the principal amount of the bonds is \$500,000 or less and the governing body obtains separate written opinions from underwriters stating the bonds are not marketable through a competitive bond sale. Bonds sold in principal amounts below \$250,000 do not require a marketability opinion. Although board staff track legislation and attend hearings, board officials were not

## Findings and Recommendations

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aware of these requirements. As a result, board personnel did not perform the required review and did not issue the required report.

### **Recommendation #2**

**We recommend the Board of Investments review its participation in issuing rural and special improvement district bonds and provide the report required by state law to the next legislature.**



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## **Certain Recent INTERCAP Loans to State Agencies May Constitute State Debt**

The Board of Investments describes its INTERCAP loan program as “a low cost, variable-rate program that lends money to Montana local governments, state agencies and the university system for the purpose of financing or refinancing the acquisition and installation of equipment or personal and real property and infrastructure improvements.” The board issues tax-exempt bonds under the state’s Municipal Finance Consolidation Act (MFCA), then loans the bond proceeds to INTERCAP borrowers. Use of the INTERCAP program by university units has been relatively stable over the last five biennia, but has almost doubled for state agencies.

The purposes for which state agencies are obtaining INTERCAP loans and the repayment sources for those loans have been changing. Initially, for example, INTERCAP loans funded vehicle purchases for the Department of Transportation’s Motor Pool, a proprietary operation funded by user charges. More recently, loans issued to fund development of a motor vehicle information technology system and for acquisition of video gambling automated accounting and reporting system data collection units, among others, are to be repaid with fees derived from the state’s taxing power or annual general fund appropriations.

Article VIII, Section 8 of the Montana Constitution states, “No state debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon.” According to the state’s bond counsel, state debt is the incurring of an obligation for which repayment extends beyond the existing budgeting and reporting period and for which the source of repayment is revenue derived from the state’s taxing power. The state’s bond counsel has stated “if the legislature can authorize an agency to borrow money without a 2/3 vote from the INTERCAP program, the source of payment of which is the State’s taxing power or general fund, and if a non appropriation clause is contained in the legislative authorization so as to keep the loan from being characterized as debt, arguably the state would or could never have

## **Disclosure Issue**

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debt.” The Legislature and Board of Investments should reconsider the appropriate use of the INTERCAP program loans.

We believe some of these recent INTERCAP loans should be considered state debt because the source of repayment is revenue derived from the state’s taxing power.

# Independent Auditor's Report & Board Financial Statements-Index

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## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Asset Value for the state of Montana Board of Investments, Retirement Funds Bond Pool, as of June 30, 2004, and 2003, and the related Statement of Changes in Net Asset Value and Statement of Investment Income and Distribution for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net asset value of the state of Montana Board of Investments, Retirement Funds Bond Pool, as of June 30, 2004, and 2003, and its changes in net asset value and investment income and distribution for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
RETIREMENT FUNDS BOND POOL FINANCIAL STATEMENTS**

**STATEMENT OF NET ASSET VALUE JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<b><u>Assets</u></b>		
Cash	\$ 0	\$ 9,519,570
Security lending cash collateral (Notes 3 and 4 )	215,688,215	82,134,484
Interest receivable	21,278,290	23,193,652
Investments managed at fair value (amortized cost of \$1,552,369,244 in 2004 and \$1,424,315,436 in 2003)(Notes 2 and 4)	<u>1,619,985,769</u>	<u>1,588,980,615</u>
Total assets	\$ <u>1,856,952,274</u>	\$ <u>1,703,828,321</u>
<b><u>Liabilities</u></b>		
Income due participants (Note 2)	11,798,842	9,800,159
Broker payable for securities purchased but not settled (Note 2)	29,517,180	0
Security lending obligations (Notes 3 and 4)	215,688,215	82,134,484
Security lending expense payable	<u>190,415</u>	<u>87,402</u>
Total liabilities	<u>257,194,652</u>	<u>92,022,045</u>
Net asset value	\$ <u>1,599,757,622</u>	\$ <u>1,611,806,276</u>
Units Outstanding (Note 2)	15,335,617	14,541,546
Unit Value (Note 2)	\$ 104.32	\$ 110.84

**STATEMENT OF CHANGES IN NET ASSET VALUE  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net asset value, beginning of year	\$ 1,611,806,276	\$ 1,725,096,994
Value of units purchased by participants	87,900,000	0
Value of units sold by participants	(2,737,550)	(213,482,974)
Changes in fair value of investments managed	<u>(97,211,104)</u>	<u>100,192,256</u>
Net asset value, end of year	\$ <u>1,599,757,622</u>	\$ <u>1,611,806,276</u>

**STATEMENT OF INVESTMENT INCOME AND DISTRIBUTION  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Interest income (Note 2 )	\$ 85,498,351	\$ 98,976,319
Amortization/accretion	12,834,615	15,293,362
Net realized gains	15,413,877	17,919,073
Security lending income	1,815,757	1,825,473
Security lending expense	(1,628,334)	(1,653,821)
Administrative expenses	(226,380)	(262,848)
Income due participants, beginning of year	<u>9,800,159</u>	<u>10,898,107</u>
Income available for distribution	123,508,045	142,995,665
Distribution	<u>111,709,203</u>	<u>133,195,506</u>
Income due participants, end of year (Note 2)	\$ <u>11,798,842</u>	\$ <u>9,800,159</u>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS  
RETIREMENT FUNDS BOND POOL**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2004 AND 2003**

**1. HISTORY AND ORGANIZATION**

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The Retirement Funds Bond Pool (RFBP) was created by the Board to allow qualifying funds, per section 17-6-201, MCA, to participate in a diversified pool. The RFBP was created on April 1, 1995, by the transfer of all fixed income and variable-rate securities owned by the Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Investments**

RFBP investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle". The RFBP portfolio includes corporate asset-backed, other corporate, U.S. government mortgage-backed, government, Yankee securities and cash investments. Corporate asset-backed securities represent debt securities collateralized by a pool of assets. U.S. government mortgage-backed securities reflect participation in a pool of residential mortgages. Government securities include direct and indirect obligations of the U.S. Treasury and state and local government bonds. Yankee bonds are U.S. dollar denominated bonds issued by foreign corporations and governments and U.S. companies issuing debt in foreign markets.

The RFBP portfolio includes structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. Some RFBP REMICs are interest-only strips (IOs). Strip investments represent the separate purchase of the principal and interest cash flows of a mortgage security. IOs receive cash flow from the interest payment component on underlying mortgage loans. These securities, purchased for portfolio diversification and a competitive rate of return, are identified and reported as government mortgage-backed securities in the investment risk and portfolio disclosures. (See Note 4 on Investment Risk Categories and Note 6 for the Year End Portfolio.)

RFBP fixed income securities pay a fixed rate of interest until maturity while the variable-rate (floating-rate) securities pay a variable interest rate until maturity. The RFBP variable-rate securities float with LIBOR (London Interbank Offered Rate) or the weighted average of the net mortgage interest rates for the mortgage loan group. The three variable-rate securities, with a total amortized cost of \$250,000 and \$450,000, respectively, as of June 30, 2004 and 2003, are identified and reported as government mortgage-backed securities in the investment risk and portfolio disclosures. (See Note 4 on Investment Risk Categories and Note 6 for the Year End Portfolio.)

The RFBP, as an internal investment pool, invests its excess cash in the Board's Short Term Investment Pool, STIP, an external investment pool. An external investment pool commingles the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio. STIP participants include both state agencies and local governments. By meeting certain conditions, STIP, as a 2a7-like pool, is allowed to use amortized cost rather than fair value to report net assets to compute unit values.

Investments are presented in the Statement of Net Asset Value at fair value. Fair values are determined primarily by reference to market prices supplied to the Board by the Board's custodial bank, State Street Bank. Amortized cost, parenthetically disclosed, represents the original cost, adjusted for premium and discount amortization where applicable. Premiums and discounts are amortized/accreted using the straight-line or scientific method to the call, average life or maturity date of the securities. Amortized cost may also be referred to as book value.

**Participant Units**

The Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds transferred all fixed income and variable-rate securities, at amortized cost, into the RFBP at the start-up date and were issued units according to the market value of each participant's portfolio. The initial unit value as of April 1, 1995, was \$100.00. Unit values thereafter are calculated weekly and at month end, based on portfolio pricing, to allow for participant transactions to occur as determined by the investment staff.

The June 30, 2004 unit value of \$104.32 decreased from a June 30, 2003 unit value of \$110.84. The yield on bonds increased during the fiscal year, which has the effect of decreasing bond prices and the pool unit value. A one percent (1%) change in interest rates is expected to have a five to seven percent (5%-7%) inverse change in the unit value. RFBP investments are considered long-term in nature.

The Value of Units Purchased and Sold by Participants of \$87.9 million and \$2.7 million, respectively, for fiscal year 2004, as compared to \$213.5 million sold for fiscal year 2003, reflects the pension funds' portfolio rebalancing. RFBP units were purchased and sold to adjust the pension funds' portfolio towards the stated equity/fixed income asset allocation.

#### Broker Receivable/Payable

RFBP security transactions are recorded as of the trade date rather than the settlement date. Because of this generally accepted practice, the RFBP portfolio at June 30 may include receivables from brokers for securities sold, but not delivered, and payables to brokers for securities purchased, but not received.

#### Other

Accumulated income, recorded as Income Due Participants, is distributed monthly on the first calendar day of each month. Realized portfolio gains/losses are distributed at least annually to the participants.

Interest income reported in the Statement of Investment Income and Distribution includes interest accruals and miscellaneous income. For fiscal year 2004, the decrease in interest income of \$13.5 million is attributed, primarily, to lower interest rates.

Administrative expenses incurred by the Board are charged daily to RFBP based on the Board's expenses applicable to RFBP. These expenses include costs for the custodial bank contract.

### **3. SECURITIES LENDING**

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit as collateral. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine.

As of June 30, 2004, the carrying and fair values of the underlying securities on loan for the RFBP were \$198,575,526 and \$209,968,206 respectively. Cash collateral provided for the securities on loan totaled \$215,688,215.

As of June 30, 2003, the carrying and fair values of the underlying securities on loan for the RFBP were \$63,891,787 and \$79,703,155 respectively. Cash collateral provided for the securities on loan totaled \$82,134,484.

#### 4. INVESTMENT RISK CATEGORIES

State of Montana investments are categorized below to give an indication of the level of risk assumed at June 30, 2004 and June 30, 2003. Category 1 includes investments that are insured or registered, or securities that are held by the Board or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Risk as of June 30, 2004

##### C a t e g o r y 1

<u>Security Investment Type</u>	<u>Securities Not On Loan</u>	<u>On Loan for Securities Collateral*</u>	<u>Not Categorized*</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Corporate Asset-Backed	\$ 57,411,212	\$ 0	\$ 0	\$ 57,411,212	\$ 57,044,332
Corporate Other	686,126,743	0	25,908,826	712,035,569	752,471,975
US Govt Mortgage-Backed	193,433,816	0	0	193,433,816	189,124,322
US Govt Direct/Indirect	293,921,182	0	168,298,000	462,219,182	488,066,522
Yankee Bonds	59,146,474	0	4,368,700	63,515,174	69,524,327
STIP	<u>63,754,291</u>	<u>0</u>	<u>0</u>	<u>63,754,291</u>	<u>63,754,291</u>
Total Investments	\$ <u>1,353,793,718</u>	\$ <u>0</u>	\$ <u>198,575,526</u>	\$ <u>1,552,369,244</u>	\$ <u>1,619,985,769</u>
Securities Lending Collateral Investment Pool			\$ <u>215,688,215</u>	\$ <u>215,688,215</u>	\$ <u>215,688,215</u>

\*At June 30, 2004, these underlying securities with fair values of \$209,968,206 were loaned for cash collateral under a security lending agreement with the state's agent.

Risk as of June 30, 2003

##### C a t e g o r y 1

<u>Security Investment Type</u>	<u>Securities Not On Loan</u>	<u>On Loan for Securities Collateral*</u>	<u>Not Categorized*</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Corporate Asset-Backed	\$ 10,000,000	\$ 0	\$ 0	\$ 10,000,000	\$ 10,000,000
Corporate Other	839,198,080	0	9,277,647	848,475,727	930,781,145
US Govt Mortgage-Backed	74,506,361	0	0	74,506,361	77,402,316
US Govt Direct/Indirect	326,000,808	0	53,620,070	379,620,878	449,442,686
Yankee Bonds	81,281,490	0	994,070	82,275,560	91,917,558
STIP	<u>29,436,910</u>	<u>0</u>	<u>0</u>	<u>29,436,910</u>	<u>29,436,910</u>
Total Investments	\$ <u>1,360,423,649</u>	\$ <u>0</u>	\$ <u>63,891,787</u>	\$ <u>1,424,315,436</u>	\$ <u>1,588,980,615</u>
Securities Lending Collateral Investment Pool			\$ <u>82,134,484</u>	\$ <u>82,134,484</u>	\$ <u>82,134,484</u>

\*At June 30, 2003, these underlying securities with fair values of \$79,703,155 were loaned for cash collateral under a security lending agreement with the state's agent.

With the exception of the US government securities, the above instruments have credit risk as measured by major credit rating services. Credit risk is defined as the risk that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires RFBP investments, at the time of purchase, to be rated investment grade as defined by Moody's or Standard & Poor's (S&P) rating services. The US government securities are guaranteed directly or indirectly by the US government.

Market risk for the above securities is caused by changes in the price or principal value of the security due to changes in interest rates and market liquidity.

As reported in the government mortgage-backed category, the RFBP portfolio holds REMICs totaling \$1,034,466 and \$1,703,480 in amortized cost, respectively, as of June 30, 2004 and June 30, 2003. These securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages. The IOs are more sensitive to prepayments by mortgagees resulting from interest rate changes than other REMIC securities.

The IO REMIC securities purchased in August and September 1992 are being reduced periodically towards zero according to the expected average life of the underlying mortgages. The IO securities amortized cost is \$250,000 as of June 30, 2004 and \$450,000 as of June 30, 2003.

Corporate asset-backed securities represent debt securities collateralized by a pool of assets. The RFBP corporate asset-backed securities are secured by lease payments and real estate. Credit risk for corporate asset backed securities is generally less than other corporate securities because assets are held by a third party.

As of June 30, 2004 and June 30, 2003, Burlington Industries, Inc. presented a legal and higher credit risk to the Board.

The Board owns a Burlington Industries, Inc., \$6 million par, 7.25% bond maturing September 15, 2005. In September 2000, the company announced a reduction of stockholders equity. Due to an increasing senior bank line and declining credit trend, the bond ratings for this issue were downgraded, in May 2001, by the Moody's and Standard & Poor's rating agencies. During fiscal year 2001, the book value of Burlington Industries Inc. was reduced from the August 31, 2000 book value of \$5,609,640 to \$2,400,000. Due to the company's filing for Chapter 11 bankruptcy protection on November 11, 2001, the book value was reduced to \$1,200,000. In October 2003, Burlington Industries, Inc. received court approval to sell its assets. Under the company's recovery plan, the Board received \$1,454,961 in August 2004 for its unsecured claim. This transaction reduced the book value to \$0 and generated a gain of \$254,961. The Board is expected to receive additional proceeds for its claim.

As of June 30, 2003, Enron Corp. presented a legal and higher credit risk to the Board.

The RFBP held a \$7 million par 6.40% Enron bond maturing July 15, 2006 and a \$7 million par 6.95% Enron bond maturing July 15, 2028. The combined book value of these securities was \$13,582,030 as of November 30, 2001. On December 12, 2001, the Enron Corp. filed for Chapter 11 bankruptcy protection. Accordingly, the November 2001 book value for the two issues was reduced to \$5.6 million as of June 30, 2002. In October 2002, the book value was reduced to \$2.8 million for both issues. In July 2003, both issues were sold, on the market, for a total of \$2.36 million.

## 5. DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The Board received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, \$5 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of \$94.669 plus accrued interest. Deutsche Bank Securities seeks damages of \$538,632 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The Board tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of \$113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the Board received \$5,683,075 in principal and interest plus \$150,000 as a consent fee. As of November 15, 2004, this matter is still pending.

## 6. YEAR END PORTFOLIO

The June 30, 2004 RFBP portfolio is listed below. The security type percentage is based on the fair value ratio of the specific security investment type to the total portfolio.

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
AA / FT WORTH HQ FINANCE TRUST	5.500	10/05/10	9,193,094	9,193,094	9,165,331	0.57%
AERO 1 HQ FINANCE TRUST	4.640	07/07/10	5,745,000	5,745,000	5,483,717	0.34%
DOT HEADQUARTERS II LEASE MTG	0.000	12/07/21	30,000,000	25,548,300	25,548,300	1.58%
J P MORGAN CHASE COMMERCIAL MORTGAGE TRUST	4.555	06/12/41	12,000,000	11,999,880	12,064,223	0.74%
J P MORGAN CHASE COMMERCIAL MORTGAGE TRUST	3.053	01/15/38	4,903,231	4,924,938	4,782,761	0.30%
<b>Corporate Asset-Backed</b>	<b>5 Issue(s)</b>		<b>61,841,325</b>	<b>57,411,212</b>	<b>57,044,332</b>	<b>3.52%</b>
AMERICA WEST AIRLINES EQUIPMENT TRUST	7.930	01/02/19	5,086,518	5,086,518	5,473,399	0.34%
AMERICAN AIRLINES 1991 EQUIPMENT TRUST	10.180	01/02/13	5,000,000	4,998,259	3,612,500	0.22%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
AMERICAN AIRLINE EQUIPMENT TRUST	6.977	05/23/21	9,198,956	9,178,080	8,164,073	0.50%
AMERICAN EXPRESS CO	4.750	06/17/09	3,000,000	2,995,028	3,041,505	0.19%
AMERICAN GEN FINANCIAL CORP	4.625	05/15/09	6,000,000	6,027,984	6,008,670	0.37%
AMERICAN TRANS AIR EQUIPMENT TRUST	8.039	07/15/17	11,211,440	11,211,440	11,372,262	0.70%
ARCHER DANIELS MIDLAND CO	10.250	01/15/06	3,500,000	3,498,321	3,890,055	0.24%
ASHLAND OIL CO	8.800	11/15/12	7,500,000	7,651,680	8,906,042	0.55%
ATCHISON TOPEKA + SANTA FE RY	6.550	01/06/13	7,160,088	7,160,088	7,630,689	0.47%
BANK ONE TEXAS	6.250	02/15/08	4,000,000	3,881,544	4,308,088	0.27%
BANKBOSTON NA	6.375	03/25/08	4,000,000	3,887,975	4,323,750	0.27%
BORDEN INC	9.250	06/15/19	5,500,000	5,349,636	5,225,000	0.32%
BORG WARNER AUTOMOTIVE INC	7.000	11/01/06	5,000,000	5,006,349	5,384,541	0.33%
BURLINGTON INDUSTRIES INC	7.250	09/15/05	6,000,000	1,200,000	2,250,000	0.14%
BURLINGTON NORTHERN RR CO	7.970	01/01/15	3,736,011	3,736,011	4,407,252	0.27%
BURLINGTON NORTHERN RR CO	6.940	01/02/14	3,414,052	3,414,052	3,761,450	0.23%
CIT GROUP INC	4.750	12/15/10	7,000,000	7,290,887	6,868,687	0.42%
CSX CORP	7.450	05/01/07	3,000,000	3,059,740	3,287,612	0.20%
CSX CORP	7.900	05/01/17	5,000,000	4,998,138	5,924,175	0.37%
CAPITAL ONE BANK	5.000	06/15/09	6,000,000	5,988,767	6,017,172	0.37%
CHAMPION INTERNATIONAL CORP	7.150	12/15/27	7,000,000	6,869,271	7,273,785	0.45%
CHICAGO + NORTH WESTERN RY	8.910	01/01/15	8,119,066	8,119,066	9,698,330	0.60%
CITIGROUP INC	6.200	03/15/09	5,000,000	4,836,101	5,394,994	0.33%
CITICORP CAPITAL II	8.015	02/15/27	4,000,000	3,970,401	4,320,779	0.27%
CONTINENTAL AIRLINES EQUIPMENT TRUST	6.545	02/02/19	6,753,544	6,753,544	6,550,938	0.40%
CORPORATE PROPERTY REIT	7.750	08/15/04	5,000,000	5,001,802	5,036,023	0.31%
CORPORATE PROPERTY REIT	7.875	03/15/16	12,000,000	12,052,032	13,877,779	0.86%
DEER PARK REFINING L P	6.470	12/15/08	5,024,200	4,980,149	5,318,605	0.33%
DELTA AIR LINES INC EQUIPMENT TRUST	10.140	08/14/12	2,000,000	2,000,000	1,260,000	0.08%
DELTA AIR LINES INC EQUIPMENT TRUST	10.140	08/14/12	4,000,000	3,987,690	2,520,000	0.16%
DELTA AIR LINES INC EQUIPMENT TRUST	10.000	06/05/11	1,971,000	1,957,965	1,241,730	0.08%
DELTA AIR LINES INC EQUIPMENT TRUST	10.000	06/05/13	3,000,000	3,000,000	1,890,000	0.12%
EL PASO NATURAL GAS CO	8.625	01/15/22	5,000,000	5,204,071	4,887,500	0.30%
ENSERCH CORP	7.125	06/15/05	5,000,000	5,012,794	5,205,646	0.32%
FIRST CHICAGO CORP	6.375	01/30/09	4,000,000	3,823,309	4,321,764	0.27%
FIRST INTERSTATE BANC SYSTEM, MONTANA	7.500	10/01/06	9,030,000	9,030,000	9,030,000	0.56%
FIRST UNION BANK N C CHARLOTTE	5.800	12/01/08	6,000,000	5,703,205	6,386,710	0.39%
FLORIDA GAS TRANSMISSION CO	9.190	11/01/24	10,000,000	9,945,842	12,294,922	0.76%
FORD MOTOR CREDIT CO	6.750	05/15/05	5,000,000	4,996,649	5,157,368	0.32%
FORD MOTOR CREDIT CO	7.375	10/28/09	8,000,000	8,006,956	8,522,216	0.53%
FORD MOTOR CREDIT CO	7.000	10/01/13	5,000,000	4,870,910	5,047,330	0.31%
GTE CORP	7.900	02/01/27	14,000,000	14,000,000	14,910,197	0.92%
GTE SOUTH INC	7.500	03/15/26	9,000,000	8,886,597	9,320,576	0.58%
GENERAL AMERICAN TRANSN CORP EQUIPMENT TR	8.420	01/01/15	7,761,232	7,761,232	8,721,966	0.54%
GENERAL ELECTRIC CAPITAL CORP	8.125	05/15/12	5,000,000	5,225,471	5,964,560	0.37%
GENERAL MOTORS ACCEPTANCE CORP	0.000	12/01/12	25,000,000	14,956,840	14,538,203	0.90%
GENERAL MOTORS ACCEPTANCE CORP	6.125	08/28/07	5,000,000	5,012,257	5,216,097	0.32%
GENERAL RE CORP	0.000	07/30/37	375,723,766	24,892,507	25,060,775	1.55%
GEORGIA PACIFIC CORP	8.250	03/01/23	5,000,000	5,046,063	5,093,750	0.31%
GEORGIA PACIFIC CORP	8.625	04/30/25	3,000,000	3,137,620	3,161,250	0.20%
ILLINOIS BELL TELEPHONE CO	6.625	02/01/25	2,000,000	1,805,523	1,976,114	0.12%
INTERNATIONAL LEASE FINANCE CORP	4.550	10/15/09	2,000,000	2,008,326	1,992,402	0.12%
INTERNATIONAL PAPER CO	6.875	11/01/23	3,000,000	2,965,502	3,055,316	0.19%
INTERNATIONAL PAPER CO	4.000	04/01/10	4,000,000	4,001,448	3,815,232	0.24%
J P MORGAN CAPITAL TRUST	7.540	01/15/27	6,000,000	5,689,849	6,232,771	0.38%
KCT INTERMODAL TRANSPORTATION CORP	6.884	08/01/18	3,617,867	3,617,867	3,898,528	0.24%
K N ENERGY INC	6.650	03/01/05	3,000,000	3,007,568	3,081,849	0.19%
KELLWOOD CO	7.625	10/15/17	12,000,000	11,823,502	12,742,284	0.79%
KERR MCGEE CORP	7.125	10/15/27	7,000,000	7,085,550	7,089,360	0.44%
KERR MCGEE CORP	6.950	07/01/24	4,000,000	3,968,880	3,987,108	0.25%
KEYCORP	7.500	06/15/06	5,000,000	4,998,087	5,400,278	0.33%



<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
KEYCORP	4.700	05/21/09	5,000,000	4,999,365	5,017,985	0.31%
MARSH + MCLENNAN COS INC	7.125	06/15/09	7,000,000	6,996,036	7,841,023	0.48%
MEAD CORP	7.350	03/01/17	11,000,000	10,992,222	12,080,274	0.75%
MED MAP L L C MONTANA	7.060	12/01/15	9,615,000	9,615,000	9,615,000	0.59%
MED MAP L L C MONTANA	7.000	06/01/21	6,140,000	6,140,000	6,140,000	0.38%
MERIDIAN TRAILER TRAIN EQUIPMENT TRUST	9.850	01/29/10	1,125,094	1,125,094	1,125,094	0.07%
MERIDIAN TRAILER TRAIN EQUIPMENT TRUST	9.850	01/29/08	1,011,058	1,011,058	1,011,058	0.06%
METLIFE INC	5.000	11/24/13	5,000,000	4,954,844	4,848,260	0.30%
MILLENIUM AMERICAN INC	7.000	11/15/06	4,000,000	3,971,397	4,110,000	0.25%
MOBIL CORP	5.940	01/15/19	8,809,983	8,809,983	9,279,998	0.57%
MORGAN J P + CO INC	0.000	04/15/27	30,000,000	5,434,163	5,398,737	0.33%
NATIONWIDE FINANCIAL SERVICES INC	8.000	03/01/27	6,000,000	5,914,742	6,367,252	0.39%
NEW YORK LIFE INSURANCE CORP	7.500	12/15/23	5,000,000	4,809,243	5,189,760	0.32%
NORFOLK SOUTHERN CORP	7.700	05/15/17	6,000,000	6,026,713	7,104,718	0.44%
NORTHWEST AIRLINES EQUIPMENT TRUST	6.810	02/01/20	10,282,313	9,894,771	9,922,432	0.61%
NORTHWEST AIRLINES EQUIPMENT TRUST	7.935	04/01/19	8,081,672	7,928,459	8,606,980	0.53%
OCCIDENTAL PETROLEUM CORP	7.200	04/01/28	13,000,000	12,856,199	14,579,820	0.90%
OCCIDENTAL PETROLEUM CORP	8.750	01/15/23	6,000,000	5,955,149	7,685,516	0.47%
OLD REPUBLIC INTERNATIONAL CORP	7.000	06/15/07	4,000,000	3,999,360	4,371,752	0.27%
PPL MONTANA LLC	8.903	07/02/20	21,835,873	21,927,169	25,629,766	1.58%
PACIFIC BELL TEL CO	7.250	11/01/27	6,000,000	5,960,634	6,204,932	0.38%
PANHANDLE EASTERN CORP	8.625	04/15/25	5,000,000	5,072,274	5,359,681	0.33%
PENNEY J C INC	9.750	06/15/21	3,609,000	3,609,000	3,735,315	0.23%
PHILLIPS PETROLEUM CO	7.125	03/15/28	11,000,000	10,849,922	11,495,506	0.71%
ST LOUIS SOUTHWESTERN RY CO	10.100	05/15/05	152,366	152,366	152,366	0.01%
SEARS ROEBUCK ACCEP CORP	7.500	10/15/27	10,000,000	10,074,711	10,355,887	0.64%
SECURITY CAP GROUP INC	7.700	06/15/28	3,000,000	3,526,928	3,529,367	0.22%
SONAT INC	7.000	02/01/18	3,000,000	2,999,690	2,362,500	0.15%
SOUTHERN UNION CO	7.600	02/01/24	7,000,000	7,035,762	7,623,411	0.47%
SOUTHWEST GAS CORP	7.500	08/01/06	6,000,000	6,059,587	6,369,779	0.39%
SOUTHWEST GAS CORP	8.375	02/15/11	6,000,000	5,985,899	6,647,593	0.41%
SOUTHWESTERN BELL TEL CO	7.000	11/15/27	3,000,000	2,996,776	3,166,417	0.20%
SUNAMERICA INC	8.125	04/28/23	13,000,000	13,017,609	15,930,948	0.98%
SUPER VALUE INC	7.875	08/01/09	3,000,000	3,003,664	3,363,563	0.21%
TENNECO PACKAGING INC	7.200	12/15/05	5,000,000	5,011,313	5,293,650	0.33%
TEXAS GAS TRANSMISSION CORP	7.250	07/15/27	3,000,000	2,769,483	3,253,453	0.20%
TRANSCONTINENTAL GAS PIPE LINE	7.250	12/01/26	3,000,000	3,002,937	2,966,250	0.18%
TRISTATE GENERATION + TRANSPORTATION ASSOC.	6.040	01/31/18	5,000,000	5,000,000	5,002,350	0.31%
TYSON FOODS INC	8.250	10/01/11	5,000,000	5,453,986	5,720,114	0.35%
US BANK NA MINNEAPOLIS	6.500	02/01/08	5,000,000	4,999,480	5,439,089	0.34%
ULTRAMAR DIAMOND SHAMROCK CORP	7.200	10/15/17	3,000,000	2,981,578	3,236,120	0.20%
UNION OIL CO CALIFORNIA	7.000	05/01/28	9,000,000	8,697,546	9,616,960	0.59%
UNION OIL CO CALIFORNIA	6.700	10/15/07	5,000,000	4,994,687	5,227,237	0.32%
UNION PACIFIC RR CO	7.750	07/01/12	4,634,149	4,634,149	5,211,795	0.32%
UNION PACIFIC RESOURCES GROUP INC	7.050	05/15/18	12,000,000	11,932,341	12,979,970	0.80%
UNION TANK CAR CO	7.125	02/01/07	6,000,000	5,998,341	6,526,340	0.40%
UNION TANK CAR CO	7.450	06/01/09	5,000,000	5,000,000	5,668,462	0.35%
UNITED AIRLINES EQUIPMENT TRUST	7.032	10/01/10	9,408,328	9,345,586	7,855,954	0.48%
WAL MART STORES INC PASS THRU TRUST	7.490	06/21/07	2,605,690	2,593,748	2,819,770	0.17%
WESTERN PROPERTIES REIT	7.200	09/15/08	3,000,000	2,925,372	3,289,035	0.20%
WESTVACO CORP	7.650	03/15/27	9,000,000	8,964,985	10,016,809	0.62%
WEYERHAEUSER CO	8.500	01/15/25	7,000,000	7,288,918	8,436,191	0.52%
WILLAMETTE INDUSTRIES INC	7.000	02/01/18	4,000,000	3,978,039	4,184,002	0.26%
WILMINGTON TRUST TUCSON ELECTRIC	10.211	01/01/09	7,995,365	7,995,365	7,995,365	0.49%
WINN DIXIE TRUST	0.000	09/01/24	70,000,000	5,200,000	5,204,080	0.32%
ZIONS BANCORPORATION	5.650	05/15/14	4,000,000	3,928,987	3,954,340	0.24%
<b>Corporate Other</b>	<b>117 Issue(s)</b>		<b>1,168,613,630</b>	<b>712,035,569</b>	<b>752,471,975</b>	<b>46.45%</b>
FEDERAL HOME LOAN POOL G10173	6.000	01/01/09	1,140,337	1,138,618	1,191,786	0.07%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
FEDERAL HOME LOAN POOL G30006	7.000	07/01/13	688,614	692,685	728,130	0.04%
FEDERAL HOME LOAN POOL E99081	4.500	09/01/18	25,813,133	25,654,687	25,281,157	1.56%
FEDERAL HOME LOAN MTG PC REMIC IO	VAR	08/15/07	1,404,956	100,000	64,993	0.00%
FEDERAL HOME LOAN MTG PC REMIC IO	VAR	09/15/07	979,309	50,000	63,909	0.00%
FEDERAL HOME LOAN POOL C01523	5.000	03/01/33	12,738,464	12,631,732	12,331,927	0.76%
FEDERAL HOME LOAN POOL E00247	5.500	10/01/08	1,455,855	1,452,537	1,496,064	0.09%
FEDERAL HOME LOAN POOL E00659	6.000	04/01/14	927,131	926,486	969,540	0.06%
FEDERAL HOME LOAN POOL E01376	4.000	04/01/18	26,822,963	26,621,439	25,571,924	1.58%
FEDERAL HOME LOAN POOL E01418	4.000	07/01/18	27,498,408	26,817,776	26,246,777	1.62%
FEDERAL HOME LOAN POOL E01425	4.500	08/01/18	27,667,779	27,594,062	27,097,582	1.67%
FEDERAL HOME LOAN POOL B13150	4.000	03/01/19	29,193,982	29,193,982	27,865,175	1.72%
FEDERAL HOME LOAN MORTGAGE PC REMIC	9.300	11/15/20	178,400	173,821	178,093	0.01%
FEDERAL NATIONAL MTG ASSN REMIC IO	VAR	08/25/07	1,377,554	100,000	104,261	0.01%
FEDERAL NATIONAL MTG ASSN REMIC	9.500	03/25/20	618,350	610,644	674,999	0.04%
FNMA POOL 109031	6.695	08/01/05	122,492	122,105	124,849	0.01%
FNMA POOL 303365	6.500	05/01/09	2,324,113	2,300,953	2,459,384	0.15%
FNMA POOL 303125	7.500	01/01/10	700,660	698,962	739,493	0.05%
FNMA POOL 303202	6.500	05/01/14	1,080,529	1,071,860	1,134,508	0.07%
FNMA POOL 303590	7.000	11/01/10	782,803	782,803	834,450	0.05%
FNMA POOL 313999	6.000	02/01/13	1,274,260	1,268,793	1,333,742	0.08%
FNMA POOL 572220	6.000	03/01/16	1,660,371	1,656,120	1,732,688	0.11%
FNMA POOL 592327	5.500	06/01/16	2,776,192	2,718,082	2,852,646	0.18%
FNMA POOL 725346	4.000	03/01/19	29,251,285	28,937,270	27,912,161	1.72%
GNMA II POOL 001254	9.500	09/20/19	33,460	33,323	37,277	0.00%
GNMA POOL 046249	10.000	12/15/10	12,940	12,882	14,385	0.00%
GNMA POOL 135544	10.000	01/15/16	72,508	72,193	82,424	0.01%
<b>Government Mortgage-Backed</b>	<b>27</b>	<b>Issue(s)</b>	<b>198,596,845</b>	<b>193,433,816</b>	<b>189,124,322</b>	<b>11.67%</b>
ASTRO OFFSHORE CORP USGG XI	6.000	12/20/19	12,499,000	12,499,000	12,499,000	0.77%
ENSCO OFFSHORE CO USGG XI	6.360	12/01/15	7,666,790	7,666,790	8,278,906	0.51%
FEDERAL HOME LOAN MORTGAGE CORP	5.125	11/07/13	13,000,000	12,916,120	12,726,662	0.79%
FEDERAL HOME LOAN MORTGAGE CORP	3.250	06/18/18	15,000,000	14,963,885	13,890,885	0.86%
FEDERAL HOME LOAN MORTGAGE CORP	4.000	06/12/13	13,000,000	11,873,901	11,866,231	0.73%
FEDERAL HOME LOAN MORTGAGE CORP	4.000	07/18/18	15,000,000	15,000,000	13,827,123	0.85%
FEDERAL HOME LOAN MORTGAGE CORP	4.500	04/02/14	11,000,000	10,957,084	10,422,665	0.64%
FEDERAL HOME LOAN MORTGAGE CORP	4.100	01/28/14	35,000,000	35,000,000	33,592,370	2.07%
FEDERAL HOME LOAN MORTGAGE CORP	5.000	01/30/14	13,000,000	12,995,886	12,582,622	0.78%
FEDERAL HOME LOAN MORTGAGE CORP	0.000	06/21/32	100,000,000	14,591,838	13,940,000	0.86%
FEDERAL HOME LOAN BANKS	6.395	06/03/14	4,000,000	3,745,507	4,354,634	0.27%
FEDERAL HOME LOAN BANKS	7.000	08/26/19	8,000,000	7,974,887	9,514,272	0.59%
FEDERAL HOME LOAN BANKS	7.450	02/03/20	15,000,000	15,095,645	18,607,500	1.15%
FEDERAL HOME LOAN MORTGAGE CORP	8.250	06/01/26	8,000,000	8,336,079	9,911,288	0.61%
FEDERAL HOME LOAN MORTGAGE CORP	0.000	06/05/28	150,000,000	29,642,265	29,910,000	1.85%
FEDERAL HOME LOAN MORTGAGE CORP	0.000	09/14/29	100,000,000	18,075,929	17,541,900	1.08%
FEDERAL HOME LOAN MORTGAGE CORP	3.500	09/15/07	10,000,000	10,134,954	9,971,550	0.62%
FEDERAL NATIONAL MORTGAGE ASSN	6.000	05/15/08	30,000,000	29,494,587	32,299,824	1.99%
FEDERAL NATIONAL MORTGAGE ASSN	7.250	01/15/10	17,000,000	16,996,729	19,353,456	1.19%
FEDERAL NATIONAL MORTGAGE ASSN	7.125	01/15/30	20,000,000	21,437,682	23,350,302	1.44%
FEDERAL NATIONAL MORTGAGE ASSN	6.625	11/15/10	5,000,000	5,138,549	5,552,237	0.34%
FEDERAL NATIONAL MORTGAGE ASSN	2.800	03/01/19	10,000,000	9,808,537	9,903,930	0.61%
GLOBAL INDUSTRIES LTD USGG XI	7.710	02/15/25	8,400,000	8,400,000	8,400,000	0.52%
STUDENT LOAN MARKETING ASSN	0.000	05/15/14	150,000,000	57,573,776	68,702,550	4.24%
TUNISIA USGG XI	6.710	02/01/24	4,000,000	3,806,408	4,000,000	0.25%
USGG SHIPPING + CENAC TOWING USGG XI	7.000	05/15/21	11,067,000	11,067,000	11,067,000	0.68%
U S ARMY HOSPITALITY FUND	7.467	05/01/32	14,708,889	14,708,889	14,708,889	0.91%
UNITED STATES TREASURY BONDS	7.250	05/15/16	21,000,000	21,717,255	25,390,313	1.57%
VESSEL MGMT SERVICES INC USGG XI	6.080	05/20/24	12,000,000	12,000,000	12,477,480	0.77%
VESSEL MGMT SERVICES INC USGG XI	6.750	06/15/25	8,600,000	8,600,000	9,422,934	0.58%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
<b>Government Direct-Indirect</b>	<b>30 Issue(s)</b>		<b>841,941,679</b>	<b>462,219,182</b>	<b>488,066,522</b>	<b>30.13%</b>
AMERICAN PRESIDENT COS LTD	8.000	01/15/24	5,000,000	4,738,226	4,500,000	0.28%
CANADIAN NATIONAL RAILWAY CO	6.800	07/15/18	6,000,000	5,966,792	6,721,720	0.41%
CANADIAN PACIFIC LTD	9.450	08/01/21	5,000,000	5,140,622	6,707,115	0.41%
EASTERN ENERGY LTD	7.250	12/01/16	5,000,000	4,944,174	5,874,148	0.36%
GREAT LAKES POWER INC	9.000	08/01/04	5,000,000	4,999,801	5,028,521	0.31%
HOUSEHOLD FINANCE CORP	6.875	03/01/07	4,000,000	3,962,825	4,325,708	0.27%
HOUSEHOLD FINANCE CORP	6.500	11/15/08	5,000,000	4,863,590	5,415,679	0.33%
IBP FINANCIAL CO CANADA	7.450	06/01/07	3,000,000	2,999,396	3,212,310	0.20%
MACMILLAN BLOEDEL LTD	7.700	02/15/26	10,000,000	9,833,726	11,182,805	0.69%
PANAMERICAN BEVERAGES INC	7.250	07/01/09	6,000,000	5,970,467	6,540,000	0.40%
TRANSCANADA PIPELINES LTD	8.500	03/20/23	5,000,000	5,137,882	5,211,323	0.32%
UNITED MEXICAN STATES	5.875	01/15/14	5,000,000	4,957,672	4,805,000	0.30%
<b>Yankee Bonds</b>	<b>12 Issue(s)</b>		<b>64,000,000</b>	<b>63,515,174</b>	<b>69,524,327</b>	<b>4.29%</b>
SHORT TERM INVESTMENT POOL			63,754,291	63,754,291	63,754,291	3.94%
<b>Cash Equivalents</b>	<b>1 Issue(s)</b>		<b>63,754,291</b>	<b>63,754,291</b>	<b>63,754,291</b>	<b>3.94%</b>
<b>RFBP Total</b>	<b>192 Issue(s)</b>		<b>2,398,747,770</b>	<b>1,552,369,244</b>	<b>1,619,985,769</b>	<b>100.00%</b>

## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Asset Value for the state of Montana Board of Investments, Trust Funds Bond Pool, as of June 30, 2004, and 2003, and the related Statement of Changes in Net Asset Value and Statement of Investment Income and Distribution for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net asset value of the state of Montana Board of Investments, Trust Funds Bond Pool, as of June 30, 2004, and 2003, and its changes in net asset value and investment income and distribution for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
TRUST FUNDS BOND POOL FINANCIAL STATEMENTS**

**STATEMENT OF NET ASSET VALUE JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<b><u>Assets</u></b>		
Cash	\$ 1,068,110	\$ 10,238,624
Security lending cash collateral (Notes 3 and 4)	174,252,479	76,755,887
Interest receivable	17,996,911	18,928,190
Investments managed at fair value (amortized cost of \$1,228,326,752 in 2004 and \$1,139,041,264 in 2003) (Notes 2 and 4)	<u>1,272,454,411</u>	<u>1,251,081,198</u>
<b>Total assets</b>	<b>\$ <u>1,465,771,911</u></b>	<b>\$ <u>1,357,003,899</u></b>
<b><u>Liabilities</u></b>		
Income due participants (Note 2)	\$ 8,651,899	\$ 7,509,196
Broker payable for securities purchased but not settled (Note 2)	20,008,860	0
Security lending obligations (Notes 3 and 4)	174,252,479	76,755,887
Security lending expense payable	<u>167,835</u>	<u>78,517</u>
<b>Total liabilities</b>	<b><u>203,081,073</u></b>	<b><u>84,343,600</u></b>
<b>Net asset value</b>	<b>\$ <u>1,262,690,838</u></b>	<b>\$ <u>1,272,660,299</u></b>
Units Outstanding (Note 2)	12,623,470	12,056,106
Unit Value (Note 2)	\$ 100.03	\$ 105.56

**STATEMENT OF CHANGES IN NET ASSET VALUE  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net asset value, beginning of year	\$ 1,272,660,299	\$ 1,168,668,577
Value of units purchased by participants	67,599,046	44,047,976
Value of units sold by participants	(9,509,724)	(21,937,900)
Changes in fair value of investments managed	<u>(68,058,783)</u>	<u>81,881,646</u>
<b>Net asset value, end of year</b>	<b>\$ <u>1,262,690,838</u></b>	<b>\$ <u>1,272,660,299</u></b>

**STATEMENT OF INVESTMENT INCOME AND DISTRIBUTION  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Interest income (Note 2)	\$ 68,116,393	\$ 73,216,763
Amortization/accretion	6,403,105	6,834,869
Net realized gains (Note 2)	12,315,173	1,355,444
Security lending income	1,510,514	1,367,131
Security lending expense	(1,334,702)	(1,239,426)
Administrative expenses	(203,928)	(225,408)
Income due participants, beginning of year	<u>7,509,196</u>	<u>6,911,434</u>
<b>Income available for distribution</b>	<b>94,315,751</b>	<b>88,220,807</b>
<b>Distribution</b>	<b><u>85,663,852</u></b>	<b><u>80,711,611</u></b>
<b>Income due participants, end of year (Note 2)</b>	<b>\$ <u>8,651,899</u></b>	<b>\$ <u>7,509,196</u></b>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS  
TRUST FUNDS BOND POOL**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2004 AND 2003**

**1. HISTORY AND ORGANIZATION**

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The Trust Funds Bond Pool (TFBP) was created by the Board to allow qualifying funds, per section 17-6-201, MCA, to participate in a diversified pool. The TFBP was created on October 1, 1995, by the transfer of all fixed income and variable-rate securities owned by six funds. These funds included the 1) Coal Severance Tax Permanent Trust, 2) Resource Indemnity Trust, 3) Coal Tax Park Trust, 4) Trust and Legacy, 5) Coal Tax Cultural Trust and 6) Treasure State Endowment Trust funds. Since the pool's creation in 1995, the funds listed below became participants in the TFBP:

University of Montana Endowment Fund	January 1996
Montana Pole Superfund	September 1996
Upper Clark Fork River Basin (UCFRB) Restoration	July 1999
Upper Clark Fork River Basin (UCFRB) Cost Recovery	July 1999
Streamside Tailings Operable Unit	July 1999
Treasure State Regional Water Systems	July 2000
Tobacco Trust Fund	January 2001
University of Montana Designated Fund	July 2002
University of Montana Other Fund*	July 2002
Montana Tech of the U of M	March 2003
Real Property Trust	September 2003
Wildlife Habitat	September 2003
Acquisition Trust	April 2004
Bair Trust Fund	April 2004
Bradley Trust	April 2004
Merritt Wheeler Trust	April 2004
Sobotka Memorial Trust	April 2004
Teakle Trust	April 2004

\*In October 2003, the University of Montana Other Fund withdrew from the TFBP.

In July 2004, Montana State University requested funds to be invested in the TFBP.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Investments**

TFBP investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle". The TFBP portfolio includes corporate asset-backed, other corporate, U.S. government mortgage-backed, government, Yankee securities and cash investments. Corporate asset-backed securities represent debt securities collateralized by a pool of assets. U.S. government mortgage-backed securities reflect participation in a pool of residential mortgages. Government securities include direct and indirect obligations of the U.S. Treasury and state and local government bonds. Yankee bonds are U.S. dollar denominated securities issued by foreign corporations and governments and U.S. companies issuing debt in foreign markets.

The TFBP portfolio includes structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. Strip investments represent the separate purchase of the principal and interest cash flows of a mortgage security. These securities, purchased for portfolio diversification and a competitive rate of return, are identified and reported as government mortgage-backed securities in the investment risk and portfolio disclosures. (See Note 4 on Investment Risk Categories and Note 7 for the Year End Portfolio.)

TFBP fixed income securities pay a fixed rate of interest until maturity while the variable-rate (floating-rate) securities pay a variable interest rate until maturity. The TFBP did not hold any variable rate securities as of June 30, 2004 and June 30, 2003.

Investments are presented in the Statement of Net Asset Value at fair value. Fair values for securities are determined primarily by reference to market prices supplied to the Board by the Board's custodial bank, State Street Bank. Amortized cost, parenthetically disclosed, represents the original cost, adjusted for premium and discount amortization where applicable. Premiums and discounts are amortized/accreted using the straight-line or scientific method to the call, average life or maturity date of the securities. Amortized cost may also be referred to as book value.

The TFBP, as an internal investment pool, invests its excess cash in the Board's Short Term Investment Pool, STIP, an external investment pool. An external investment pool commingles the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio. STIP participants include both state agencies and local governments. By meeting certain conditions, STIP, as a 2a7-like pool, is allowed to use amortized cost rather than fair value to report net assets to compute unit values.

#### Participant Units

The Coal Severance Tax Permanent Trust, Resource Indemnity Trust, Coal Tax Park Trust, Trust and Legacy, Coal Tax Cultural Trust, and Treasure State Endowment Trust funds transferred all fixed income and variable-rate securities, at amortized cost, into the TFBP at the start-up date and were issued units according to the fair value of each participant's portfolio. The initial unit value as of October 1, 1995, was \$100.00. Unit values are calculated weekly and at month end, based on portfolio pricing, to allow for participant transactions to occur as determined by the investment staff.

The June 30, 2004 unit value of \$100.03 decreased from a June 30, 2003 unit value of \$105.56. The yield on bonds increased during the fiscal year, which has the effect of decreasing bond prices and the pool unit value. A one percent (1%) change in interest rates is expected to have a five to seven percent (5%-7%) inverse change in the unit value. TFBP investments are considered long-term in nature and participants require long-term time horizons.

#### Broker Receivable/Payable

TFBP security transactions are recorded as of the trade date rather than the settlement date. Because of this generally accepted practice, the TFBP portfolio at June 30 may include receivables from brokers for securities sold, but not delivered, and payables to brokers for securities purchased, but not received.

#### Other

Accumulated income, recorded as Income Due Participants, is distributed monthly on the first calendar day of each month. Realized portfolio gains/losses are distributed at least annually to the participants.

Interest income reported in the Statement of Investment Income and Distribution includes interest accruals and miscellaneous income. For fiscal year 2004, the decrease in interest income of \$5.1 million is attributed, primarily, to lower interest rates. Net realized gains increased by \$10.9 million in fiscal year 2004 due to market conditions.

Administrative expenses incurred by the Board are charged daily to TFBP based on the Board's expenses applicable to TFBP. These expenses include costs for the custodial bank contract.

### **3. SECURITIES LENDING**

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received U.S. dollar currency cash, U.S. government securities, and irrevocable bank letters of credit as collateral. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine.

As of June 30, 2004, the carrying and fair value of the underlying securities on loan for the Trust Funds Bond Pool was \$164,208,920 and \$172,167,230, respectively. The collateral provided for the securities on loan totaled \$177,281,934 representing \$174,252,479 in cash and \$3,029,455 in securities collateral.

As of June 30, 2003, the carrying and fair value of the underlying securities on loan for the Trust Funds Bond Pool was \$57,555,310 and \$70,451,001, respectively. The cash collateral provided for the securities on loan totaled \$76,755,887.

#### 4. INVESTMENT RISK CATEGORIES

State of Montana investments are categorized below to give an indication of the level of risk assumed at June 30, 2004 and June 30, 2003. Category 1 includes investments that are insured or registered, or securities that are held by the Board or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Risk as of June 30, 2004

##### Category 1

<u>Security Investment Type</u>	<u>Securities Not On Loan</u>	<u>On Loan for Securities Collateral*</u>	<u>Not Categorized*</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Corporate Asset-Backed	\$ 61,012,957	\$ 0	\$ 0	\$ 61,012,957	\$ 60,172,310
Corporate Other	504,213,488	0	13,195,489	517,408,977	546,932,475
US Govt Mortgage-Backed	150,317,964	0	0	150,317,964	147,756,275
US Govt Direct/Indirect	225,256,904	2,531,803	144,490,702	372,279,409	385,437,965
Yankee Bonds	68,920,280	0	3,990,926	72,911,206	77,757,388
State and Local Government	9,892,524	0	0	9,892,524	9,894,283
STIP	<u>44,503,715</u>	<u>0</u>	<u>0</u>	<u>44,503,715</u>	<u>44,503,715</u>
Total Investments	\$ <u>1,064,117,832</u>	\$ <u>2,531,803</u>	\$ <u>161,677,117</u>	\$ <u>1,228,326,752</u>	\$ <u>1,272,454,411</u>
Securities Lending Collateral Investment Pool			\$ <u>174,252,479</u>	\$ <u>174,252,479</u>	\$ <u>174,252,479</u>

\*At June 30, 2004, these underlying securities, with fair values of \$2,965,830 and \$169,201,400, respectively, were loaned for securities and cash collateral under a security lending agreement with the state's agent.



Risk as of June 30, 2003

C a t e g o r y 1

<u>Security Investment Type</u>	<u>Securities</u> <u>Not</u> <u>On Loan</u>	<u>On Loan for</u> <u>Securities</u> <u>Collateral*</u>	<u>Not</u> <u>Categorized*</u>	<u>Carrying</u> <u>Amount</u>	<u>Fair</u> <u>Value</u>
Corporate Asset-Backed	\$ 12,255,000	\$ 0	\$ 0	\$ 12,255,000	\$ 12,255,000
Corporate Other	604,884,995	0	6,505,228	611,390,223	664,571,494
US Govt Mortgage-Backed	76,290,821	0	0	76,290,821	79,160,041
US Govt Direct/Indirect	245,586,129	0	51,050,082	296,636,211	340,815,409
Yankee Bonds	92,470,191	0	0	92,470,191	104,278,410
State and Local Government	13,884,836	0	0	13,884,836	13,886,862
STIP	<u>36,113,982</u>	<u>0</u>	<u>0</u>	<u>36,113,982</u>	<u>36,113,982</u>
 Total Investments	 \$ <u>1,081,485,954</u>	 \$ <u>0</u>	 \$ <u>57,555,310</u>	 \$ <u>1,139,041,264</u>	 \$ <u>1,251,081,198</u>
 Securities Lending Collateral Investment Pool			 \$ <u>76,755,887</u>	 \$ <u>76,755,887</u>	 \$ <u>76,755,887</u>

\*At June 30, 2003, these underlying securities, with a fair value of \$70,451,001, were loaned for cash collateral under a security lending agreement with the state's agent.

With the exception of the U.S. government securities, the above instruments have credit risk as measured by major credit rating services. Credit risk is defined as the risk that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires TFBP investments, at the time of purchase, to be rated investment grade as defined by Moody's or Standard & Poor's (S&P) rating services. The U.S. government securities are guaranteed directly or indirectly by the U.S. government.

Market risk for the above securities is caused by changes in the price or principal value of the security due to changes in interest rates and market liquidity.

As reported in the U.S. government mortgage-backed category, the TFBP portfolio holds REMICs totaling \$429,878 and \$706,427, respectively, at amortized cost, as of June 30, 2004 and June 30, 2003. These securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages.

Corporate asset-backed securities represent debt securities collateralized by a pool of assets. The TFBP corporate asset-backed security is secured by lease payments and real estate. Credit risk for corporate asset backed securities is generally less than other corporate securities because assets are held by a third party.

As of June 30, 2004 and June 30, 2003, Burlington Industries, Inc. presented a legal and higher credit risk to the Board.

The Board owns a Burlington Industries, Inc., \$4 million par, 7.25% bond maturing September 15, 2005. In September 2000, the company announced a reduction of stockholders equity. Due to an increasing senior bank line and declining credit trend, the bond ratings for this issue were downgraded, in May 2001, by the Moody's and Standard & Poor's rating agencies. During fiscal year 2001, the book value of Burlington Industries Inc. was reduced from the August 31, 2000 book value of \$3,739,760 to \$1,600,000. Due to the company's filing for Chapter 11 bankruptcy protection on November 11, 2001, the book value was reduced to \$800,000. In October 2003, Burlington Industries, Inc. received court approval to sell its assets. Under the company's recovery plan, the Board received \$969,974 in August 2004 for its unsecured claim. This transaction reduced the book value to \$0 and generated a gain of \$169,974. The Board is expected to receive additional proceeds for its claim.

As of June 30, 2003, Enron Corp. presented a legal and higher credit risk to the Board.

The TFBP held a \$2 million par, 6.75% Enron bond maturing August 1, 2009, a \$3 million par 6.40% Enron bond maturing July 15, 2006 and a \$3 million par 6.95% Enron bond maturing July 15, 2028. The combined book value of these securities was \$7,560,870 as of November 30, 2001. On December 12, 2001, the Enron Corp. filed for Chapter 11 bankruptcy protection. Accordingly, the November 2001 book value for the three issues was reduced to \$3.2 million as of June 30, 2002.

In October 2002, the book value was reduced to \$1.6 million for the three issues. In July 2003, the three issues were sold, on the market, for a total of \$1.35 million.

## 5. PARTICIPANT LOAN

In accordance with Senate Bill 495 enacted by the 2001 Legislature, the Coal Severance Tax Permanent Trust loaned 483,604 TFBP shares, with a book value of \$46,366,904, to the Trust and Legacy fund on July 2, 2001. The loan proceeds were deposited in the Trust and Legacy Fund. A loan receivable was recorded in the Coal Severance Tax Permanent Trust and a corresponding liability was recorded in the Guarantee Fund, a General Fund sub-fund. The August 2002 Special Legislative Session approved the request to record this activity in a state special revenue fund of the Office of Public Instruction rather than in the Guarantee Fund. On June 30, 2004, the Trust and Legacy Fund paid \$1,820,816 to the Coal Severance Tax Permanent Trust reducing the TFBP shares on loan to 464,613 with a corresponding book value of \$44,546,088.

## 6. DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The Board received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, \$8 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a “breach of contract” for the March 25 2002 sale of the bond at a price of \$94.669 plus accrued interest. Deutsche Bank Securities seeks damages of \$861,811 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The Board tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of \$113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the Board received \$9,092,920 in principal and interest plus \$240,000 as a consent fee. As of November 15, this matter is still pending.

## 7. YEAR END PORTFOLIO

The June 30, 2004 TFBP portfolio is listed below. The security type percentage is based on the fair value ratio of the specific security investment type to the total portfolio.

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
AA / FT WORTH HQ FINANCE TRUST	5.50	10/05/10	11,951,022	11,951,022	11,914,930	0.94%
AERO 1 HQ FINANCE TRUST	4.64	07/07/10	9,255,000	9,255,000	8,834,083	0.69%
DOT HEADQUARTERS II LEASE MTG	0.00	12/07/21	20,000,000	17,032,200	17,032,200	1.34%
J P MORGAN CHASE COMMERCIAL MORTGAGE TR	4.56	06/12/41	8,000,000	7,999,920	8,042,815	0.63%
J P MORGAN CHASE COMMERCIAL MORTGAGE TR	3.05	01/15/38	14,709,692	14,774,815	14,348,282	1.13%
<b>Corporate Asset-Backed</b>	<b>5 Issue(s)</b>		<b>63,915,714</b>	<b>61,012,957</b>	<b>60,172,310</b>	<b>4.73%</b>
AMERICA WEST AIRLINES EQUIPMENT TRUST	7.93	01/02/19	3,391,012	3,391,012	3,648,933	0.29%
AMERICAN AIRLINES 1991 EQUIPMENT TRUST	9.73	09/29/14	5,000,000	4,979,630	3,650,000	0.29%
AMERICAN AIRLINE EQUIPMENT TRUST	6.98	05/23/21	6,132,637	6,119,813	5,442,716	0.43%
AMERICAN EXPRESS CO	4.75	06/17/09	2,000,000	1,996,686	2,027,670	0.16%
AMERICAN GEN FINANCIAL CORP	4.63	05/15/09	4,000,000	4,018,656	4,005,780	0.31%
AMERICAN TRANS AIR EQUIPMENT TRUST	8.04	07/15/17	6,036,929	6,036,929	6,123,526	0.48%
ARCHER DANIELS MIDLAND CO	10.25	01/15/06	5,000,000	4,997,339	5,557,221	0.44%
ASHLAND OIL CO	8.80	11/15/12	2,500,000	2,537,920	2,968,681	0.23%
BANK ONE TEXAS N A	6.25	02/15/08	4,000,000	3,881,544	4,308,088	0.34%
BANKBOSTON NA	6.38	03/25/08	4,000,000	3,887,975	4,323,750	0.34%
BORDEN INC	9.25	06/15/19	1,500,000	1,458,595	1,425,000	0.11%
BORG WARNER AUTOMOTIVE INC	7.00	11/01/06	1,000,000	1,008,556	1,076,908	0.08%
BURLINGTON INDUSTRIES INC	7.25	09/15/05	4,000,000	800,000	1,500,000	0.12%
BURLINGTON NORTHERN RR CO	7.97	01/01/15	3,736,011	3,736,011	4,407,252	0.35%
BURLINGTON NORTHERN SANTA FE RY	7.16	01/02/20	13,591,952	13,591,952	15,014,973	1.18%
CIT GROUP EQUIPMENT TRUST	6.49	01/05/21	11,637,451	11,637,451	12,232,151	0.96%
CIT GROUP INC	7.38	04/02/07	5,000,000	5,322,128	5,470,185	0.43%
CIT GROUP INC	4.75	12/15/10	3,000,000	3,124,666	2,943,723	0.23%
CNA FINANCIAL CORP	6.45	01/15/08	5,000,000	5,047,940	5,257,810	0.41%
CSX CORP	7.45	05/01/07	2,000,000	1,999,144	2,191,741	0.17%
CSX CORP	7.90	05/01/17	5,000,000	4,998,138	5,924,175	0.47%
CAPITAL ONE BANK	5.00	06/15/09	4,000,000	3,992,511	4,011,448	0.31%
CHAMPION INTERNATIONAL CORP	7.15	12/15/27	3,000,000	2,939,952	3,117,337	0.24%
CHICAGO + NORTH WESTERN RY	8.91	01/01/15	4,059,533	4,059,533	4,849,165	0.38%
CITIGROUP INC	6.20	03/15/09	5,000,000	4,836,101	5,394,994	0.42%
CITICORP CAPITAL II	8.02	02/15/27	6,000,000	5,955,601	6,481,169	0.51%
CLEVELAND ELECTRIC ILLUM CO	7.13	07/01/07	5,000,000	4,992,002	5,445,315	0.43%
CONAGRA INC	9.88	11/15/05	5,000,000	5,094,526	5,470,193	0.43%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
CONTINENTAL AIRLINES EQUIPMENT TRUST	6.55	02/02/19	5,909,351	5,909,351	5,732,071	0.45%
CORPORATE PROPERTY REIT	7.75	08/15/04	5,000,000	5,001,802	5,036,023	0.40%
CORPORATE PROPERTY REIT	7.88	03/15/16	3,000,000	2,993,882	3,469,445	0.27%
DEER PARK REFINING L P	6.47	12/15/08	2,512,100	2,482,733	2,659,302	0.21%
DELTA AIR LINES INC EQUIPMENT TRUST	10.14	08/14/12	1,000,000	1,000,000	630,000	0.05%
DELTA AIR LINES INC EQUIPMENT TRUST	10.14	08/14/12	2,000,000	1,993,845	1,260,000	0.10%
DELTA AIR LINES INC EQUIPMENT TRUST	10.00	06/05/13	2,000,000	2,000,000	1,260,000	0.10%
ENSERCH CORP	7.13	06/15/05	5,000,000	5,012,761	5,205,646	0.41%
FIRST CHICAGO CORP	6.38	01/30/09	4,000,000	3,823,309	4,321,764	0.34%
FIRST INTERSTATE BANC SYSTEM MONTANA	7.50	10/01/06	3,870,000	3,870,000	3,870,000	0.30%
FIRST UNION CORP	8.00	08/15/09	5,000,000	5,003,978	5,040,712	0.40%
FIRST UNION BANK	5.80	12/01/08	4,000,000	3,802,136	4,257,806	0.33%
FLORIDA GAS TRANSMISSION CO	9.19	11/01/24	5,000,000	5,000,000	6,147,461	0.48%
FLORIDA GAS TRANSMISSION CO	7.00	07/17/12	3,000,000	2,996,501	3,233,743	0.25%
FORD MOTOR CREDIT CO	6.75	05/15/05	5,000,000	5,002,307	5,157,368	0.40%
FORD MOTOR CREDIT CO	7.38	10/28/09	7,000,000	7,006,086	7,456,939	0.59%
FORD MOTOR CREDIT CO	7.00	10/01/13	5,000,000	4,870,910	5,047,330	0.40%
GTE CORP	7.90	02/01/27	6,000,000	6,000,000	6,390,085	0.50%
GTE SOUTH INC	7.50	03/15/26	6,000,000	5,924,398	6,213,718	0.49%
GENERAL AMERICAN TRANS CORP EQUIPMT TR	8.42	01/01/15	7,761,232	7,761,232	8,721,966	0.68%
GENERAL MOTORS ACCEPTANCE CORP	0.00	12/01/12	25,000,000	14,657,604	14,538,203	1.14%
GENERAL MOTORS ACCEPTANCE CORP	6.13	08/28/07	5,000,000	5,012,257	5,216,097	0.41%
GEORGIA PACIFIC CORP	8.25	03/01/23	5,000,000	5,053,668	5,093,750	0.40%
GEORGIA PACIFIC CORP	8.63	04/30/25	2,000,000	2,091,746	2,107,500	0.17%
ILLINOIS BELL TELEPHONE CO	6.63	02/01/25	2,000,000	1,805,523	1,976,114	0.16%
INTERNATIONAL LEASE FINANCE CORP	4.55	10/15/09	3,000,000	3,012,489	2,988,603	0.23%
INTERNATIONAL PAPER CO	6.88	11/01/23	2,000,000	1,977,001	2,036,877	0.16%
INTERNATIONAL PAPER CO	4.00	04/01/10	6,000,000	5,999,790	5,722,848	0.45%
JP MORGAN CAPITAL TRUST	7.54	01/15/27	4,000,000	3,793,232	4,155,180	0.33%
KCT INTERMODAL TRANSPORTATION CORP	6.88	08/01/18	1,808,933	1,808,933	1,949,264	0.15%
KELLWOOD CO	7.63	10/15/17	8,000,000	7,919,653	8,494,856	0.67%
KERR MCGEE CORP	7.13	10/15/27	3,000,000	3,036,664	3,038,297	0.24%
KERR MCGEE CORP	6.95	07/01/24	3,000,000	2,976,660	2,990,331	0.23%
KEYCORP	4.70	05/21/09	5,000,000	4,999,365	5,017,985	0.39%
MARSH + MCLENNAN COS INC	7.13	06/15/09	5,000,000	5,060,408	5,600,731	0.44%
MEAD CORP	7.35	03/01/17	4,000,000	3,997,171	4,392,827	0.34%
MED MAP L L C MONTANA	7.06	12/01/15	4,485,000	4,485,000	4,485,000	0.35%
MED MAP L L C MONTANA	7.00	06/01/21	4,720,000	4,720,000	4,720,000	0.37%
METLIFE INC	5.00	11/24/13	5,000,000	4,954,844	4,848,260	0.38%
MILLENIUAM AMERICA INC	7.00	11/15/06	1,000,000	992,849	1,027,500	0.08%
MOBIL CORP	5.94	01/15/19	8,809,983	8,809,983	9,279,998	0.73%
MORGAN J P + CO INC	0.00	04/15/27	70,000,000	12,679,714	12,597,053	0.99%
NATIONWIDE FINANCIAL SERVICES INC	8.00	03/01/27	4,000,000	3,943,161	4,244,834	0.33%
NORFOLK SOUTHERN CORP	7.70	05/15/17	4,000,000	4,012,648	4,736,478	0.37%
NORFOLK SOUTHERN CORP	7.35	05/15/07	6,500,000	6,503,282	7,119,995	0.56%
NORTHWEST AIRLINES EQUIPMENT TRUST	6.81	02/01/20	11,139,172	10,848,043	10,749,301	0.84%
NORTHWEST AIRLINES EQUIPMENT TRUST	7.94	04/01/19	4,040,836	3,997,205	4,303,490	0.34%
OCCIDENTAL PETROLEUM CORP	7.20	04/01/28	7,000,000	6,877,909	7,850,672	0.62%
OCCIDENTAL PETROLEUM CORP	8.75	01/15/23	4,000,000	4,000,000	5,123,677	0.40%
OLD REPUBLIC INTERNATIONAL CORP	7.00	06/15/07	3,000,000	2,999,520	3,278,814	0.26%
PPL MONTANA LLC	8.90	07/02/20	21,835,873	21,927,169	25,629,766	2.01%
PACIFIC BELL	7.25	11/01/27	4,000,000	3,973,756	4,136,621	0.32%
PHILLIPS PETROLEUM CO	7.13	03/15/28	4,000,000	3,945,426	4,180,184	0.33%
SEARS ROEBUCK ACCEP CORP	7.50	10/15/27	5,000,000	5,015,809	5,177,944	0.41%
SECURITY CAP GROUP INC	7.70	06/15/28	2,000,000	2,351,286	2,352,911	0.18%
SONAT INC	7.00	02/01/18	2,000,000	1,999,794	1,575,000	0.12%
SOUTHERN UNION CO	7.60	02/01/24	8,000,000	7,426,404	8,712,470	0.68%
SOUTHWEST GAS CORP	7.50	08/01/06	4,000,000	4,161,949	4,246,519	0.33%
SOUTHWEST GAS CORP	8.38	02/15/11	8,000,000	8,007,966	8,863,457	0.70%
SOUTHWESTERN BELL TEL CO	7.00	11/15/27	2,000,000	1,997,850	2,110,944	0.17%
SUNAMERICA INC	8.13	04/28/23	7,000,000	7,038,648	8,578,203	0.67%
SUPERVALU INC	7.88	08/01/09	7,000,000	6,988,797	7,848,313	0.62%
TEXAS GAS TRANSMISSION CORP	7.25	07/15/27	2,000,000	1,846,322	2,168,969	0.17%
TRANSCONTINENTAL GAS PIPE LINE	7.25	12/01/26	2,000,000	2,010,955	1,977,500	0.16%
TRISTATE GENERATIONTRANSPORTATION ASSOC	6.04	01/31/18	5,000,000	5,000,000	5,002,350	0.39%
TYSON FOODS INC	8.25	10/01/11	5,000,000	5,583,871	5,720,114	0.45%
ULTRAMAR DIAMOND SHAMROCK CORP	7.20	10/15/17	2,000,000	1,987,719	2,157,413	0.17%
UNION OIL CO CALIFORNIA	7.00	05/01/28	6,000,000	5,778,520	6,411,307	0.50%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
UNION PACIFIC RR CO	7.75	07/01/12	2,317,074	2,317,074	2,605,898	0.20%
UNION PACIFIC RESOURCES GROUP INC	7.05	05/15/18	6,000,000	5,940,805	6,489,985	0.51%
UNION TANK CAR CO	7.13	02/01/07	2,000,000	1,999,447	2,175,447	0.17%
UNION TANK CAR CO	7.45	06/01/09	5,000,000	5,000,000	5,668,462	0.45%
UNITED AIRLINES EQUIPMENT TRUST	7.03	10/01/10	9,408,328	9,306,823	7,855,954	0.62%
WESTERN PROPERTIES REIT	7.20	09/15/08	1,000,000	975,124	1,096,345	0.09%
WESTVACO CORP	7.65	03/15/27	6,000,000	5,976,657	6,677,873	0.52%
WEYERHAEUSER CO	8.50	01/15/25	8,000,000	9,244,284	9,641,361	0.76%
WILLAMETTE INDUSTRIES INC	7.00	02/01/18	1,000,000	938,230	1,046,001	0.08%
WILMINGTON TRUST TUCSON ELECTRIC	10.21	01/01/09	3,997,682	3,997,682	3,997,682	0.31%
WINN DIXIE	0.00	09/01/24	64,509,810	4,800,000	4,795,917	0.38%
ZIONS BANCORPORATION	5.65	05/15/14	3,000,000	2,946,741	2,965,755	0.23%
<b>Corporate Other</b>	<b>108 Issue(s)</b>		<b>648,210,901</b>	<b>517,408,977</b>	<b>546,932,475</b>	<b>42.98%</b>
FEDERAL HOME LOAN POOL G10814	5.50	05/01/13	921,494	920,882	947,879	0.07%
FEDERAL HOME LOAN POOL G10173	6.00	01/01/09	488,716	487,979	510,766	0.04%
FEDERAL HOME LOAN POOL G30006	7.00	07/01/13	541,054	541,054	572,102	0.04%
FEDERAL HOME LOAN POOL E99081	4.50	09/01/18	20,281,747	20,157,254	19,863,767	1.56%
FEDERAL HOME LOAN PC REMIC	9.15	10/15/20	186,967	184,903	186,928	0.01%
FEDERAL HOME LOAN PC REMIC	6.25	11/15/07	246,724	244,975	251,670	0.02%
FEDERAL HOME LOAN POOL C01523	5.00	03/01/33	8,492,309	8,421,155	8,221,285	0.65%
FEDERAL HOME LOAN POOL E00247	5.50	10/01/08	610,520	609,128	627,382	0.05%
FEDERAL HOME LOAN POOL E00659	6.00	04/01/14	1,297,983	1,297,081	1,357,356	0.11%
FEDERAL HOME LOAN POOL E01376	4.00	04/01/18	17,881,975	17,747,626	17,047,949	1.34%
FEDERAL HOME LOAN POOL E01418	4.00	07/01/18	18,332,272	17,680,324	17,497,852	1.37%
FEDERAL HOME LOAN POOL E01425	4.50	08/01/18	18,445,186	18,396,041	18,065,055	1.42%
FEDERAL HOME LOAN POOL B13150	4.00	03/01/19	19,462,655	19,462,655	18,576,783	1.46%
FNMA POOL 254233	5.00	03/01/17	8,473,828	8,211,424	8,518,514	0.67%
FNMA POOL 254631	5.00	02/01/18	10,354,295	10,489,565	10,401,457	0.82%
FNMA POOL 303202	6.50	05/01/14	1,620,793	1,607,791	1,701,761	0.13%
FNMA POOL 313999	6.00	02/01/13	637,130	634,396	666,871	0.05%
FNMA POOL 572220	6.00	03/01/16	1,660,371	1,656,120	1,732,688	0.14%
FNMA POOL 592327	5.50	06/01/16	2,135,532	2,090,832	2,194,343	0.17%
FNMA POOL 725346	4.00	03/01/19	19,500,856	19,291,513	18,608,107	1.46%
GNMA POOL 032974	9.50	09/15/09	29,177	27,975	31,646	0.00%
GNMA POOL 038164	10.00	01/15/10	70,971	70,786	78,354	0.01%
GNMA POOL 039321	10.00	12/15/09	27,872	27,800	30,688	0.00%
GNMA POOL 042547	10.00	10/15/10	8,807	8,782	9,766	0.00%
GNMA POOL 065459	11.50	04/15/13	5,804	5,747	6,729	0.00%
GNMA POOL 166690	9.00	06/15/16	16,256	16,170	17,705	0.00%
GNMA POOL 281467	9.00	09/15/19	28,111	28,007	30,875	0.00%
<b>Government Mortgage-Backed</b>	<b>27 Issue(s)</b>		<b>151,759,406</b>	<b>150,317,964</b>	<b>147,756,275</b>	<b>11.61%</b>
BENDER SHIPBUILDING + REPAIR USGG XI	6.20	09/30/12	10,987,530	10,987,530	10,987,530	0.86%
FEDERAL HOME LOAN MORTGAGE CORP	5.13	11/07/13	12,000,000	11,922,572	11,747,688	0.92%
FEDERAL HOME LOAN MORTGAGE CORP	3.25	06/18/18	20,000,000	19,951,847	18,521,180	1.45%
FEDERAL HOME LOAN MORTGAGE CORP	4.00	06/12/13	12,000,000	10,960,524	10,953,444	0.86%
FEDERAL HOME LOAN MORTGAGE CORP	4.00	07/18/18	15,000,000	15,000,000	13,827,123	1.09%
FEDERAL HOME LOAN MORTGAGE CORP	4.50	04/02/14	9,000,000	8,964,887	8,527,635	0.67%
FREDDIE MAC	4.10	01/28/14	30,000,000	30,000,000	28,793,460	2.26%
FEDERAL HOME LOAN MORTGAGE CORP	5.00	01/30/14	12,000,000	11,996,203	11,614,728	0.91%
FEDERAL HOME LOAN MORTGAGE CORP	0.00	06/21/32	100,000,000	14,591,838	13,940,000	1.09%
FEDERAL HOME LOAN BANKS	6.40	06/03/14	6,000,000	5,618,260	6,531,951	0.51%
FEDERAL HOME LOAN BANKS	7.00	08/26/19	7,000,000	6,962,906	8,324,988	0.65%
FEDERAL HOME LOAN BANKS	7.45	02/03/20	10,000,000	10,063,763	12,405,000	0.97%
FEDERAL HOME LOAN MORTGAGE CORP	8.25	06/01/26	7,000,000	7,294,069	8,672,377	0.68%
FEDERAL HOME LOAN MORTGAGE CORP	0.00	06/05/28	50,000,000	9,880,755	9,970,000	0.78%
FEDERAL HOME LOAN MORTGAGE CORP	0.00	09/14/29	100,000,000	18,075,929	17,541,900	1.38%
FEDERAL HOME LOAN MORTGAGE CORP	3.50	09/15/07	20,000,000	20,269,908	19,943,100	1.57%
FEDERAL NATIONAL MORTGAGE ASSN	6.00	05/15/08	15,000,000	14,747,294	16,149,912	1.27%
FEDERAL NATIONAL MORTGAGE ASSN	7.25	01/15/10	15,000,000	14,957,951	17,076,579	1.34%
FEDERAL NATIONAL MORTGAGE ASSN	7.13	01/15/30	25,000,000	27,075,700	29,187,878	2.29%
FEDERAL NATIONAL MORTGAGE ASSN	2.80	03/01/19	7,000,000	6,865,976	6,932,751	0.54%
GLOBAL INDUSTRIES LTD USGG XI	7.71	02/15/25	8,400,000	8,400,000	8,400,000	0.66%
REINAUER MARITIME CO LLC USGG XI	6.50	06/30/28	19,776,000	19,776,000	19,776,000	1.55%
STUDENT LOAN MARKETING ASSN	0.00	05/15/14	50,000,000	18,649,109	22,900,850	1.80%
T T BARGE SERVICES USGG XI	6.45	12/16/12	1,732,300	1,732,300	1,732,300	0.14%
TUNISIA AID USGG XI	6.71	02/01/24	4,000,000	3,806,408	4,000,000	0.31%
U S ARMY HOSPITALITY FUND	7.47	05/01/32	9,805,926	9,805,926	9,805,926	0.77%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
UNITED STATES TREASURY BONDS	7.25	05/15/16	14,000,000	14,449,755	16,926,875	1.33%
VESSEL MGMT SERVICES INC USGG XI	6.08	05/20/24	19,472,000	19,472,000	20,246,791	1.59%
<b>Government Direct-Indirect</b>	<b>28 Issue(s)</b>		<b>610,173,756</b>	<b>372,279,409</b>	<b>385,437,965</b>	<b>30.29%</b>
CANADIAN NATIONAL RY CO	6.80	07/15/18	4,000,000	3,980,795	4,481,146	0.35%
EASTERN ENERGY LTD	7.25	12/01/16	10,000,000	9,888,348	11,748,296	0.92%
GREAT LAKES POWER INC	9.00	08/01/04	10,000,000	9,999,603	10,057,041	0.79%
HOUSEHOLD FINANCE CORP	6.88	03/01/07	3,000,000	2,972,119	3,244,281	0.25%
HOUSEHOLD FINANCE CORP	6.50	11/15/08	5,000,000	4,865,042	5,415,679	0.43%
IBP FINANCIAL CO CANADA	7.45	06/01/07	3,000,000	2,999,396	3,212,310	0.25%
MACMILLAN BLOEDEL LTD	7.70	02/15/26	5,000,000	4,893,033	5,591,403	0.44%
PANAMERICAN BEVERAGES INC	7.25	07/01/09	7,000,000	6,986,038	7,630,000	0.60%
TRANSAMERICA FINANCIAL CORP	0.00	09/01/12	20,000,000	11,199,321	11,555,910	0.91%
TRANSCANADA PIPELINES LTD	8.50	03/20/23	5,000,000	5,212,167	5,211,323	0.41%
UNITED MEXICAN STATES	5.88	01/15/14	10,000,000	9,915,344	9,610,000	0.75%
<b>Yankee Bonds</b>	<b>11 Issue(s)</b>		<b>82,000,000</b>	<b>72,911,206</b>	<b>77,757,388</b>	<b>6.11%</b>
BUTTE SILVER BOW MONTANA TAX INDL	6.89	07/01/05	3,225,000	3,225,000	3,225,000	0.25%
MONTANA STATE TAXABLE RENEW (4 ISSUES)	7.35-7.40	8/1/2009-12	735,000	733,242	170,000	0.01%
MONTANA STATE BOARD HOUSING	8.45	08/01/39	1,145,000	1,145,000	1,145,000	0.09%
MONTANA CRP (83 ISSUES)	6.00-8.00	11/15/05-15	4,789,283	4,789,283	4,789,283	0.38%
<b>State/Local Government</b>	<b>89 Issue(s)</b>		<b>9,894,283</b>	<b>9,892,524</b>	<b>9,894,283</b>	<b>0.78%</b>
SHORT TERM INVESTMENT POOL			44,503,715	44,503,715	44,503,715	3.50%
<b>Cash Equivalents</b>	<b>1 Issue(s)</b>		<b>44,503,715</b>	<b>44,503,715</b>	<b>44,503,715</b>	<b>3.50%</b>
<b>TFBP Total</b>	<b>269 Issue(s)</b>		<b>1,610,457,775</b>	<b>1,228,326,752</b>	<b>1,272,454,411</b>	<b>100.00%</b>

## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Asset Value for the state of Montana Board of Investments, Short Term Investment Pool, as of June 30, 2004, and 2003, and the related Statement of Changes in Net Asset Value and Statement of Investment Income and Distribution for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net asset value of the state of Montana Board of Investments, Short Term Investment Pool, as of June 30, 2004, and 2003, and its changes in net asset value and investment income and distribution for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
SHORT TERM INVESTMENT POOL FINANCIAL STATEMENTS**

**STATEMENT OF NET ASSET VALUE JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<u>Assets</u>		
Cash	\$ 203,235	\$ 252,434
Interest receivable	403,650	619,408
Security lending cash collateral (Notes 3 and 4)	0	0
Unrealized loss (Note 2)	37,638	15,180
Investments managed at fair value (amortized cost of \$1,479,812,941 in 2004 and \$1,420,403,394 in 2003)(Notes 2 and 4)	<u>1,479,775,303</u>	<u>1,420,388,214</u>
Total assets	\$ <u>1,480,419,826</u>	\$ <u>1,421,275,236</u>
<u>Liabilities</u>		
Security lending expense payable	\$ 0	\$ 0
Income due participants	203,236	252,441
Security lending obligations(Notes 3 and 4)	<u>0</u>	<u>0</u>
Total liabilities	\$ <u>203,236</u>	\$ <u>252,441</u>
Net asset value	\$ <u>1,480,216,590</u>	\$ <u>1,421,022,795</u>
Units Outstanding (Note 2)	1,480,216,590	1,421,022,795
Unit Value (Note 2)	\$ 1	\$ 1

**STATEMENT OF CHANGES IN NET ASSET VALUE  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net asset value, beginning of year	\$ 1,421,022,795	\$ 1,502,237,435
Value of units purchased by participants	6,284,553,085	6,003,654,371
Value of units sold by participants	<u>(6,225,359,290)</u>	<u>(6,084,869,011)</u>
Net asset value, end of year	\$ <u>1,480,216,590</u>	\$ <u>1,421,022,795</u>

**STATEMENT OF INVESTMENT INCOME AND DISTRIBUTION  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Investment income (Note 2)	\$ 16,110,043	\$ 21,605,295
Security lending income	0	209
Security lending expense	0	(187)
Administrative expenses	(310,392)	(322,224)
Income due participants, beginning of year	<u>252,441</u>	<u>1,002,463</u>
Income available for distribution	16,052,092	22,285,556
Distribution	<u>15,848,856</u>	<u>22,033,115</u>
Income due participants, end of year	\$ <u>203,236</u>	\$ <u>252,441</u>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS  
SHORT TERM INVESTMENT POOL - NOTES TO FINANCIAL STATEMENTS**

**JUNE 30, 2004 AND 2003**

**1. HISTORY AND ORGANIZATION**

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The Short Term Investment Pool (STIP) was created by the Board to allow qualifying funds, per sections 17-6-201, 202 and 204, MCA, to participate in a diversified pool. Although state agencies are legally required to invest in STIP, local governments may voluntarily participate in STIP.

The purpose of STIP is to obtain the highest possible return, yet maintain a highly liquid position whereby funds may be invested for relatively short periods, one day or more, depending upon the participant's anticipated use of the funds. The investments and the income from STIP are owned by the participants, as they purchase units, and are managed on their behalf by the Board.

Although STIP is not registered with the Securities and Exchange Commission (SEC) as an investment company, the Board has as policy that STIP will, and does, operate in a manner consistent with the SEC's rule 2a7 of the Investment Company Act of 1940. In meeting certain conditions, STIP, as a 2a7-like pool, is allowed to use amortized cost rather than fair value to report net assets to compute unit values.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Investments**

STIP investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle". The STIP portfolio may include asset-backed securities, commercial paper, corporate and government securities, repurchase agreements, and variable-rate (floating-rate) instruments. These securities are purchased to provide shareholders with a diversified portfolio earning a competitive total rate of return.

Asset-backed securities represent debt securities collateralized by a pool of mortgage and non-mortgage assets such as trade and loan receivables, equipment leases, credit cards, etc. Commercial paper is unsecured short-term debt with maturities ranging from 1 to 270 days. Commercial paper issued at a discount, direct or by brokers, is backed by bank credit lines. Repurchase agreements (REPOs) represent an agreement between a seller and a buyer, usually of US government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and stated time. Variable-rate (floating-rate) securities pay a variable rate of interest until maturity. The STIP portfolio's variable-rate securities float with LIBOR (London Interbank Offered Rate).

Investments held are reported at fair value, annually, based on market prices supplied to the Board by the Board's custodial bank. The difference between amortized cost and fair value is reflected as an unrealized gain or loss in the investments managed. The STIP investment portfolio consists of securities with a maximum maturity of 397 days or less with the exception of securities having rate reset dates. The portfolio is carried at amortized cost or book value.

**Participant Units**

The STIP unit value is fixed at \$1 for both participant buys and sells. A purchased unit earns income on the purchase date and ceases to earn income on the day before the unit is sold. Participants may buy or sell fractional shares. For fiscal years 2004 and 2003, income was distributed on the first calendar day of each month, with the exception of the June distribution. Income for June 2004 and June 2003 was distributed on the last calendar day of the month. Participants may automatically reinvest their income in additional units.

During fiscal years 2004 and 2003, the Board did not provide or obtain any legally binding guarantees to support the value of the participant units.

**Broker Receivable/Payable**

STIP security transactions are recorded as of the trade date rather than the settlement date. Because of this generally accepted practice, the STIP portfolio at June 30 may include receivables from brokers for securities sold, but not delivered, and payables to brokers for securities purchased, but not received.



## Other

Administrative expenses incurred by the Board are charged daily to STIP based on the Board's expenses applicable to STIP.

### 3. SECURITIES LENDING

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine. On June 30, 2004 and June 30, 2003, the Board had no credit risk exposure to borrowers.

As of June 30, 2004 and June 30, 2003, there were no securities on loan.

### 4. INVESTMENT RISK CATEGORIES

State of Montana investments are categorized below and on the following page to give an indication of the level of risk assumed at June 30, 2004 and June 30, 2003. Category 1 includes investments that are insured or registered or securities that are held by the Board or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Risk as of June 30, 2004

<u>C a t e g o r y 1</u>					
<u>Security Investment Type</u>	<u>Securities Not On Loan</u>	<u>On Loan for Securities Collateral</u>	<u>Not Categorized</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Asset-Backed Securities	940,831,210	0	0	940,831,210	940,844,477
Repurchase Agreements	34,000,000	0	0	34,000,000	34,000,000
Variable-Rate (Floating-Rate)	<u>504,981,731</u>	<u>0</u>	<u>0</u>	<u>504,981,731</u>	<u>504,930,826</u>
Total Investment	\$ <u>1,479,812,941</u>	\$ <u>0</u>	\$ <u>0</u>	\$ <u>1,479,812,941</u>	\$ <u>1,479,775,303</u>
Securities Lending Collateral Investment Pool		\$ <u>0</u>	\$ <u>0</u>	\$ <u>0</u>	\$ <u>0</u>

**Risk as of June 30, 2003**

**C a t e g o r y 1**

<b><u>Security Investment Type</u></b>	<b><u>Securities Not On Loan</u></b>	<b><u>On Loan for Securities Collateral</u></b>	<b><u>Not Categorized</u></b>	<b><u>Carrying Amount</u></b>	<b><u>Fair Value</u></b>
Asset-Backed Securities	733,397,874	0	0	733,397,874	733,410,024
Repurchase Agreements	56,000,000	0	0	56,000,000	56,000,000
Variable-Rate (Floating-Rate)	631,005,520	0	0	631,005,520	630,978,190
<b>Total Investment</b>	<b>\$ 1,420,403,394</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 1,420,403,394</b>	<b>\$ 1,420,388,214</b>
<b>Securities Lending Collateral Investment Pool</b>		<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>

STIP investments' credit risk is measured by investment grade ratings given individual securities. Board of Investment's policy requires that STIP investments have the highest rating in the short term category by at least one Nationally Recognized Statistical Rating Organizations (NRSRO). The six NRSRO's include Standard and Poors, Moody's, Duff and Phelps, Fitch, IBCA and Thompson's Bank Watch.

Asset-backed securities have less credit risk than do securities not backed by pledged assets, while market risk for asset-backed securities is the same as market risk for similar non asset-backed securities.

While variable-rate securities have credit risk identical to similar fixed-rate securities, their interest rate (income) is more sensitive to interest rate changes. However, their market risk (value/price) may be less volatile than fixed-rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

The Board is not aware of any legal risks regarding any STIP investments.

## 5. YEAR END PORTFOLIO

The June 30, 2004 STIP portfolio is listed below. The security type percentage is based on the fair value ratio of the specific security investment type to the total portfolio.

<b><u>Security Name</u></b>	<b><u>Coupon</u></b>	<b><u>Maturity</u></b>	<b><u>Par</u></b>	<b><u>Book Value</u></b>	<b><u>Fair Value</u></b>	<b><u>% of Total</u></b>
CLIPPER RECEIVABLES CORP	discount	07/01/04	40,000,000	40,000,000	39,998,320	2.70%
MILLSTONE FUNDING LTD	discount	07/01/04	20,000,000	20,000,000	19,999,400	1.35%
HANNOVER FUNDING CO	discount	07/02/04	17,949,000	17,948,457	17,947,913	1.21%
HIGH PEAK FUNDING	discount	07/06/04	20,000,000	19,996,917	19,996,300	1.35%
RHINELAND FUNDING CAPITAL	discount	07/07/04	20,000,000	19,996,233	19,995,600	1.35%
RHINELAND FUNDING CAPITAL	discount	07/08/04	15,040,000	15,036,695	15,036,225	1.02%
EIFFEL FUNDING LTD	discount	07/09/04	20,000,000	19,995,067	19,994,460	1.35%
LOCKHART FUNDING LLC	discount	07/09/04	20,000,000	19,995,111	19,994,500	1.35%
EDISON ASSET SECURITIZATION	discount	07/12/04	20,000,000	19,993,217	19,992,600	1.35%
AUTOBAHN FUNDING CO LLC	discount	07/13/04	20,000,000	19,992,467	19,991,840	1.35%
LOCKHART FUNDING LLC	discount	07/13/04	20,000,000	19,992,467	19,991,840	1.35%
FIVE FINANCE INC	discount	07/14/04	20,000,000	19,991,911	19,991,280	1.35%
EDISON ASSET SECURITIZATION	discount	07/15/04	20,000,000	19,991,367	19,990,760	1.35%
HBOS TREASURY SERVICES PLC	discount	07/16/04	20,200,000	20,190,321	20,189,678	1.36%
EMINENT FUNDING I, LTD	discount	07/19/04	20,000,000	19,988,300	19,987,660	1.35%
DNA FINANCE CORP	discount	07/20/04	20,830,000	20,817,357	20,816,690	1.41%
PB FINANCE DEL INC	discount	07/21/04	20,000,000	19,987,111	19,986,460	1.35%
SUNBELT FUNDING CORP	discount	07/22/04	20,000,000	19,986,583	19,985,940	1.35%
EMINENT FUNDING I, LTD	discount	07/23/04	20,000,000	19,985,700	19,985,060	1.35%
SUNBELT FUNDING CORP	discount	07/26/04	20,000,000	19,983,889	19,983,240	1.35%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
NEPTUNE FUNDING CORP	discount	07/27/04	20,000,000	19,983,244	19,982,600	1.35%
BEETHOVEN FUNDING CORP	discount	07/28/04	20,000,000	19,982,300	19,981,640	1.35%
CHECK POINT CHARLIE, INC	discount	07/29/04	13,825,000	13,813,064	13,812,751	0.93%
DEALERS CAPITAL ACCESS TRUST INC	discount	07/30/04	12,700,000	12,688,133	12,687,719	0.86%
FIVE FINANCE INC	discount	07/30/04	10,000,000	9,990,656	9,990,330	0.68%
NEPTUNE FUNDING CORP	discount	07/30/04	15,000,000	14,985,983	14,985,495	1.01%
PB FINANCE DEL INC	discount	08/02/04	20,000,000	19,978,133	19,977,460	1.35%
MANHATTAN ASSET FUNDING	discount	08/03/04	20,000,000	19,976,900	19,976,200	1.35%
STARBIRD FUNDING CORP	discount	08/04/04	20,000,000	19,976,389	19,975,700	1.35%
MANHATTAN ASSET FUNDING	discount	08/05/04	20,000,000	19,975,500	19,974,800	1.35%
ADVANTAGE ASSET SECURITIES CORP	discount	08/06/04	15,033,000	15,014,359	15,013,848	1.01%
NEWBURY FUNDING	discount	08/09/04	18,500,000	18,474,347	18,473,693	1.25%
MPF TWO LTD	discount	08/10/04	14,000,000	13,979,778	13,979,266	0.94%
STARBIRD FUNDING CORP	discount	08/10/04	15,000,000	14,978,333	14,977,785	1.01%
LOCKHART FUNDING LLC	discount	08/11/04	20,000,000	19,971,983	19,971,300	1.35%
NEWBURY FUNDING	discount	08/11/04	11,400,000	11,382,732	11,382,307	0.77%
CHECK POINT CHARLIE, INC	discount	08/12/04	20,850,000	20,818,378	20,817,620	1.41%
DEALERS CAPITAL ACCESS TRUST INC	discount	08/13/04	20,000,000	19,968,228	19,967,480	1.35%
BLUE BELL FUNDING LTD	discount	08/16/04	20,000,000	19,964,989	19,964,220	1.35%
BEETHOVEN FUNDING CORP	discount	08/18/04	20,000,000	19,963,200	19,962,440	1.35%
AUTOBAHN FUNDING CO LLC	discount	08/20/04	19,195,000	19,157,676	19,156,936	1.29%
MICA FUNDING LLC	discount	08/23/04	20,000,000	19,958,778	19,958,000	1.35%
ARTH CAPITAL CORP	discount	08/24/04	15,426,000	15,393,605	15,393,004	1.04%
ARTH CAPITAL CORP	discount	08/25/04	11,778,000	11,752,808	11,752,348	0.79%
BLACK DIAMOND USA	discount	08/25/04	15,000,000	14,967,917	14,967,330	1.01%
STARBIRD FUNDING CORP	discount	08/25/04	20,000,000	19,957,528	19,956,760	1.35%
CHECK POINT CHARLIE, INC	discount	08/27/04	20,000,000	19,953,767	19,964,560	1.35%
CIESCO LP	discount	08/30/04	20,000,000	19,953,333	19,952,560	1.35%
STANFIELD VICTORIA FINANCE	2.350	06/30/05	40,000,000	40,000,000	40,032,560	2.71%
<b>ASSET-BACKED SECURITIES</b>			<b>941,726,000</b>	<b>940,831,210</b>	<b>940,844,477</b>	<b>63.58%</b>
STATE STREET REPO	1.140	07/01/04	34,000,000	34,000,000	34,000,000	2.30%
<b>REPURCHASE AGREEMENT</b>			<b>34,000,000</b>	<b>34,000,000</b>	<b>34,000,000</b>	<b>2.30%</b>
RATHGAR CAPITAL US CORP	1.140	07/06/04	25,000,000	25,000,000	24,999,750	1.69%
WHITE PINE FINANCE LLC	1.194	07/15/04	50,000,000	49,999,714	50,000,000	3.38%
CIT GROUP INC	1.440	08/26/04	40,000,000	40,000,000	39,987,976	2.70%
LIQUID FUNDING LTD	1.221	09/14/04	50,000,000	50,000,000	49,999,500	3.38%
GOLDMAN SACHS GROUP	1.200	02/07/05	40,000,000	40,000,000	39,921,600	2.70%
SIGMA FINANCE	1.350	03/10/05	50,000,000	49,994,822	50,067,000	3.38%
TANGO FINANCE CORP	1.373	03/11/05	50,000,000	49,996,534	49,987,500	3.38%
LINKS FINANCE LLC	1.189	03/15/05	50,000,000	49,996,479	49,992,000	3.38%
BELFORD U S CAP CO LLC	1.110	04/01/05	50,000,000	50,000,000	49,992,500	3.38%
WHISTLEJACKET CAPITAL LTD	1.470	04/15/05	50,000,000	49,994,182	49,993,000	3.38%
PARKLAND USA LLC	1.250	04/19/05	50,000,000	50,000,000	49,990,000	3.38%
<b>VARIABLE-RATE (FLOATING RATES)</b>			<b>505,000,000</b>	<b>504,981,731</b>	<b>504,930,826</b>	<b>34.12%</b>
<b>TOTAL STIP</b>			<b>1,480,726,000</b>	<b>1,479,812,941</b>	<b>1,479,775,303</b>	<b>100.00%</b>

## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Asset Value for the state of Montana Board of Investments, Montana Domestic Equity Pool, as of June 30, 2004, and 2003, and the related Statement of Changes in Net Asset Value and Statement of Investment Income and Distribution for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net asset value of the state of Montana Board of Investments, Montana Domestic Equity Pool, as of June 30, 2004, and 2003, and its changes in net asset value and investment income and distribution for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
MONTANA DOMESTIC EQUITY POOL FINANCIAL STATEMENTS  
STATEMENT OF NET ASSET VALUE JUNE 30, 2004 AND 2003**

	<b>MDEP</b>	<b>MDEP</b>
	<b><u>2004</u></b>	<b>(Note 1) <u>2003</u></b>
<b><u>Assets</u></b>		
Cash	\$	\$
Security lending cash collateral (Notes 3 and 4)	20,641,660	19,085,755
Dividend receivable	2,047,731	1,917,421
Interest receivable	26,061	10,291
Investments managed at fair value (carrying value of \$2,479,060,702 in 2004 and \$2,474,861,073 in 2003)(Notes 2 and 4)	<u>2,902,284,868</u>	<u>2,577,470,669</u>
<b>Total assets</b>	<b>\$ <u>2,925,000,320</u></b>	<b>\$ <u>2,598,484,136</u></b>
<b><u>Liabilities</u></b>		
Income due participants	\$ 2,611,096	\$ 2,041,555
Security lending expense payable	21,517	6,778
Administrative fee payable	0	18,034
Security lending obligations (Notes 3 and 4)	<u>20,641,660</u>	<u>19,085,755</u>
<b>Total liabilities</b>	<b><u>23,274,273</u></b>	<b><u>21,152,122</u></b>
<b>Net asset value</b>	<b>\$ <u>2,901,726,047</u></b>	<b>\$ <u>2,577,332,014</u></b>
Units Outstanding (Note2)	23,600,184	24,311,482
Unit Value (Note 2)	\$ 122.95	\$ 106.01

**STATEMENT OF CHANGES IN NET ASSET VALUE  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net asset value, beginning of year	\$ 2,577,332,014	\$ 1,883,181,181
Value of MTCP units purchased by participants (Note 2)	0	14,398,568
Value of MTCP units sold by participants (Note 2)	0	(26,880,630)
Transfer of BGI and DFA investments to MDEP (Notes 1 and 2)	0	740,000,000
Value of MDEP units purchased by participants (Note 2)	62,463,000	25,000,000
Value of MDEP units sold by participants (Note 2)	(86,459,939)	0
Changes in fair value of investments managed (Note 2)	<u>348,390,972</u>	<u>(58,367,105)</u>
<b>Net asset value, end of year</b>	<b>\$ <u>2,901,726,047</u></b>	<b>\$ <u>2,577,332,014</u></b>

**STATEMENT OF INVESTMENT INCOME AND DISTRIBUTION  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Investment income (Note 2)	\$ 33,950,029	\$ 29,807,948
Security lending income	356,505	382,440
Security lending expense	(264,065)	(308,191)
Administrative expenses (Note 2)	(1,657,067)	(984,146)
Income due participants, beginning of year	<u>2,041,555</u>	<u>1,478,632</u>
<b>Income available for distribution</b>	<b>34,426,957</b>	<b>30,376,683</b>
<b>Distribution (Note 2)</b>	<b><u>31,815,861</u></b>	<b><u>28,335,128</u></b>
<b>Income due participants, end of year</b>	<b>\$ <u>2,611,096</u></b>	<b>\$ <u>2,041,555</u></b>

The accompanying notes are an integral part of these financial statements.

STATE OF MONTANA BOARD OF INVESTMENTS  
MONTANA DOMESTIC EQUITY - NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

1. HISTORY AND ORGANIZATION

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The Montana Common Stock Pool (MTCP) was created by the Board to allow retirement and endowment funds, per section 17-6-201, MCA, the opportunity to participate in the equity market via a diversified pool. MTCP was created as of July 1, 1980, by the transfer of all common stock owned by the Public Employees' Retirement System, Teachers' Retirement System, and other funds into MTCP.

In March 1996, the Board approved the Investment Policy Statement to reflect the name change from the Montana Common Stock Pool to the Montana Stock Pool. The Montana Stock Pool is referred to as "Montcomp" or MTCP. This policy statement provided for the investment in common or preferred stock. The Investment Policy Statement has been subsequently revised and approved to allow investment in the following security types:

September 1996	Securities convertible into common or preferred stocks
June 2000	Equity derivatives
January 2004	American Depositary Receipts (ADR's)

The Board authorized creation of the Montana Domestic Equity Pool (MDEP) in April 2003. This pool combines the domestic equity investments of the Montana Stock Pool (MTCP), Barclays Global Investors (BGI) and Dimensional Fund Advisors (DFA). Effective May 1, 2003, the Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds transferred all the BGI S&P 500 Equity Index Fund A and the DFA Small Cap Subtrust investments totaling \$740 million, at cost, from the All Other Funds portfolio to the new pool. The pension and endowment funds also exchanged their investment in the Montana Stock Pool (MTCP) for units in the new Montana Domestic Equity Pool (MDEP).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investments

MDEP investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle". The MDEP portfolio may include common stock, equity index, preferred stock, convertible equity securities, American Depositary Receipts (ADR's) and equity derivatives. Common stock represents ownership units (shares) of a public corporation. Common stock owners are entitled to vote on director selection and other important matters as well as receive dividends on their holdings. Equity index investments are investments in selected mutual funds whose equity portfolios match a broad based index or composite. Preferred stock, as a class of stock, pays dividends at a specified rate and has preference in the payment of dividends and liquidation of assets. Preferred stock holders, ordinarily, do not have voting rights. Convertible securities are securities carrying the right to exchange, or "convert" the instrument for other securities of the issuer or of another issuer. This definition most often applies to preferred stocks or corporate bonds carrying the right to exchange for a fixed number of shares of the issuer's common stock. ADR's are receipts issued by a US depositary bank representing shares of a foreign stock or bonds held abroad by the foreign sub-custodian of the American depositary bank. Equity derivatives "derive" their value from other equity instruments such as futures and options.

In June 2000, the Board approved the securitization of MTCP cash by investing in an equity derivative, the State Street Stock Performance Index Futures Fund (SPIFF). Portfolio cash is swept daily into SPIFF maintaining 100% equity exposure through holdings of stock index futures.

The MDEP, as an internal investment pool, invested its excess cash, on creation, in the Board's Short Term Investment Pool, STIP, an external investment pool. An external investment pool commingles the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio. STIP participants include both state agencies and local governments. By meeting certain conditions, STIP, as a 2a7-like pool, is allowed to use amortized cost rather than fair value to report net assets to compute unit values. In July 2003, the STIP account was closed and a SPIFF account was opened to securitize MDEP cash by investing in an equity derivative.

In January 2003, the Board approved a staff recommendation to hire Dimensional Fund Advisors (DFA), as an external manager, to invest in domestic small market capitalization (small cap) companies. Market capitalization refers to the value of a corporation as determined by the market price of its issued and outstanding common stock. DFA's Small Cap Subtrust targets those companies whose market capitalization comprises the smallest 8 percent of the total market universe. The total market universe is defined as the aggregate capitalization of the NYSE, AMEX and NASDAQ firms.

Investments are presented in the statement of Net Asset Value at fair value. Equity investments, on valuation date, are stated at the closing price of the security's primary exchange. Carrying value, parenthetically disclosed, represents the equity security purchase price plus a fixed commission where applicable.

#### Participant Units

The Public Employees' Retirement System and the Teachers' Retirement System transferred all stock owned into MTCP at the start-up date and were issued units according to the fair value of their contribution, retaining their original total cost basis. The initial unit value as of July 1, 1980, was \$1,000. Unit values thereafter and until March 31, 2000 were calculated weekly and at the close of the last business day of the month, based on the fair value of MTCP equity holdings and other assets. Effective April 1, 2000, the unit values are calculated daily. Daily unit value calculations were discontinued as of January 1, 2003. Since January 2003, MTCP unit values are calculated weekly and at the close of the last business day of the month. Depending on stock market conditions and the investment officer's decision, MDEP participants may then buy or sell units on the first calendar day of each month based on the month end values.

On July 1, 1994, the initial unit value changed from \$1,000 to \$100. This change was required for the Board's new accounting system. On August 17, 2000, shareholders, on record, received one MTCP share for each MTCP share held as the result of a 2:1 split. The unit value on August 31, 2000, prior to the split, was \$1,014 while the unit value, after the split, was \$507.

On May 1, 2003, the pension funds transferred all the Barclays Global Investors (BGI) S&P 500 Equity Index Fund A and the Dimensional Fund Advisors (DFA) Small Cap Subtrust investments, at cost, to the MDEP. On the same date, the pension and endowment funds transferred their MTCP investments, at cost, to the MDEP. The pension and endowment funds were issued units according to the fair value of each participant's portfolio. The initial MDEP unit value on May 1, 2003 was \$100. On conversion date, MTCP participants exchanged approximately 5.8 million MTCP units, valued at \$302 per unit, for 24.1 million MDEP units, issued at \$100 per unit.

As reported in the Statement of Changes in Net Asset Value, the value of MDEP units purchased by participants increased \$37 million in fiscal year 2004 while the value of MDEP units sold increased by \$86 million based on changes in the market. This change is based on fiscal year 2004 consisting of 12 months as compared to fiscal year 2003 consisting of two months. The value of MTCP units purchased in fiscal year 2004 decreased by \$14 million to \$0 due to the MDEP creation on May 1, 2003. The fiscal year 2004 and 2003 changes are the result of an asset allocation decision and do not reflect a change from the stated investment policy to increase retirement fund exposure to equity investments. MTCP participant purchases and sales from July 2002 to March 2003 were based on a MTCP per unit value ranging from \$259 per unit to \$308 per unit. In June 2003, the MDEP participants purchased units at \$105 per unit to fund \$25 million for the DFA US Small Cap Trust. In fiscal year 2004, MDEP participants bought and sold units at a price ranging from \$108 to \$125 per unit. The increase of \$407 million in the Change in Fair Value of Investments Managed reflects the equity market appreciation since fiscal year 2003.

#### Broker Receivable/Payable

MDEP security transactions are recorded as of trade date rather than settlement date. Because of this generally accepted practice, the MDEP portfolio at June 30 may include receivables from brokers for securities sold but not delivered, and payables to brokers for securities purchased but not received.

#### Other

Investment income reported in the Statement of Investment Income and Distribution includes dividend accruals, tax reclaim accruals, SPIFF gain/losses and miscellaneous income. MDEP dividends are recorded on the ex-dividend date.

The MDEP Income Available for Distribution is distributed as of the first calendar day of each month. Administrative expenses incurred by the Board are charged daily to MDEP based on the Board's expenses applicable to MDEP. For fiscal year 2004, these expenses include \$1,038,000 for the Board and the custodial bank contract and

\$619,067 in accruals for external manager fees. For fiscal year 2003, these expenses include \$966,446 for the Board and the custodial bank contract and \$17,700 in accruals for external manager fees for May and June 2003.

### **3. SECURITIES LENDING**

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit as collateral. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine.

As of June 30, 2004, the carrying and fair values of the underlying securities on loan for the Montana Domestic Equity Pool were \$18,798,876 and \$20,254,272 respectively. The collateral provided for the securities on loan totaled \$20,641,660 in cash.

As of June 30, 2003, the carrying and fair values of the underlying securities on loan for the Montana Domestic Equity Pool were \$19,578,118 and \$18,747,547 respectively. The collateral provided for the securities on loan totaled \$19,085,755 in cash.

### **4. INVESTMENT RISK CATEGORIES**

State of Montana investments are categorized on the next page to give an indication of the level of risk assumed at June 30, 2004 and June 30, 2003. Category 1 includes investments that are insured or registered or securities that are held by the Board or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.



**Risk as of June 30, 2004**

**C a t e g o r y 1**

<b><u>Security Investment Type</u></b>	<b><u>Securities Not On Loan</u></b>	<b><u>On Loan for Securities Collateral*</u></b>	<b><u>Not Categorized*</u></b>	<b><u>Carrying Amount</u></b>	<b><u>Fair Value</u></b>
Common Stock Pool	\$ 1,616,461,902	\$ 0	\$ 18,798,876	\$ 1,635,260,778	\$ 1,941,940,158
Equity Index Fund	544,162,050	0	0	544,162,050	596,835,124
DFA Small Cap Subtrust	260,000,000	0	0	260,000,000	323,104,286
SPIFF	39,637,874	0	0	39,637,874	40,405,300
STIP	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
<b>Total Investment</b>	<b>\$ <u>2,460,261,826</u></b>	<b>\$ <u>0</u></b>	<b>\$ <u>18,798,876</u></b>	<b>\$ <u>2,479,060,702</u></b>	<b>\$ <u>2,902,284,868</u></b>
Securities Lending Collateral Investment Pool		\$ <u>20,641,660</u>	\$ <u>20,641,660</u>	\$ <u>20,641,660</u>	\$ <u>20,641,660</u>

\* At June 30, 2004, the underlying securities with fair values of \$20,254,272 were loaned for cash collateral under a security lending agreement with the state's agent.

**Risk as of June 30, 2003**

**C a t e g o r y 1**

<b><u>Security Investment Type</u></b>	<b><u>Securities Not On Loan</u></b>	<b><u>On Loan for Securities Collateral*</u></b>	<b><u>Not Categorized*</u></b>	<b><u>Carrying Amount</u></b>	<b><u>Fair Value</u></b>
Common Stock Pool	\$ 1,655,692,724	\$ 0	\$ 19,578,118	\$ 1,675,270,842	\$ 1,817,071,361
Equity Index Fund	710,000,000	0	0	710,000,000	661,781,844
DFA Small Cap Subtrust	55,000,000	0	0	55,000,000	62,981,234
SPIFF	34,575,711	0	0	34,575,711	35,621,710
STIP	<u>14,520</u>	<u>0</u>	<u>0</u>	<u>14,520</u>	<u>14,520</u>
<b>Total Investment</b>	<b>\$ <u>2,455,282,955</u></b>	<b>\$ <u>0</u></b>	<b>\$ <u>19,578,118</u></b>	<b>\$ <u>2,474,861,073</u></b>	<b>\$ <u>2,577,470,669</u></b>
Securities Lending Collateral Investment Pool		\$ <u>19,085,755</u>	\$ <u>19,085,755</u>	\$ <u>19,085,755</u>	\$ <u>19,085,755</u>

\* At June 30, 2003, the underlying securities with fair values of \$18,747,547 were loaned for cash collateral under a security lending agreement with the state's agent.

**5. OWENS-CORNING COMPLAINT**

On October 11, 2002, the Board received a summons and complaint regarding the bankruptcy of Owens-Corning. The company seeks a determination that the dividend payments paid from October 1996 through July 2000 represent “fraudulent transfers under Chapter 11 Bankruptcy provisions and applicable state law, and are, therefore, voidable”. The complaint states the Montana Board of Investments was the “recipient of dividends in the amount of \$357,099 for the relevant period”. The Board has prepared a response to the complaint.

## 6. YEAREND PORTFOLIO

The June 30, 2004 MDEP portfolio is listed below. The security type percentage is based on the fair value ratio of the specific security investment type to the total portfolio.

<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
GENERAL ELECTRIC CO	2,576,200	55,496,833	83,468,880	2.88%
MICROSOFT CORP	2,721,000	96,323,133	77,711,760	2.68%
PFIZER INC	2,078,260	80,487,746	71,242,753	2.45%
CITIGROUP INC	1,461,866	24,958,920	67,976,769	2.34%
EXXON MOBIL CORP	1,439,912	38,973,263	63,946,492	2.20%
JOHNSON + JOHNSON	804,000	15,125,692	44,782,800	1.54%
AMERICAN INTERNATIONAL GROUP INC	599,750	30,545,337	42,750,180	1.47%
INTEL CORP	1,544,000	12,881,172	42,614,400	1.47%
WAL MART STORES INC	750,000	38,897,531	39,570,000	1.36%
CISCO SYSTEMS INC	1,605,000	22,120,032	38,038,500	1.31%
INTERNATIONAL BUSINESS MACHINES	408,000	18,509,180	35,965,200	1.24%
J P MORGAN CHASE + CO	875,900	30,371,102	33,958,643	1.17%
CHEVRONTXACO CORP	333,350	21,042,296	31,371,569	1.08%
COCA COLA CO	605,000	30,989,290	30,540,400	1.05%
WELLS FARGO + CO	533,000	9,121,533	30,503,590	1.05%
VIACOM INC	818,000	32,793,750	29,218,960	1.01%
TEXAS INSTRUMENTS INC	1,059,000	43,837,687	25,606,620	0.88%
MERCK + CO INC	539,000	11,770,324	25,602,500	0.88%
ABBOTT LABS	615,000	5,371,910	25,067,400	0.86%
DISNEY WALT CO	970,000	28,515,583	24,725,300	0.85%
VERIZON COMMUNICATIONS	674,308	19,918,151	24,403,207	0.84%
DELL INC	681,000	24,867,930	24,393,420	0.84%
ALTRIA GROUP INC	480,000	20,193,362	24,024,000	0.83%
UNITED TECHNOLOGIES CORP	258,000	8,737,819	23,601,840	0.81%
BANK AMERICA CORP	275,000	20,087,258	23,270,500	0.80%
BANK NEW YORK INC	705,000	31,181,709	20,783,400	0.72%
TYCO INTERNATIONAL LTD	580,000	7,400,829	19,221,200	0.66%
AMGEN INC	351,000	18,361,169	19,154,070	0.66%
HEWLETT PACKARD CO	890,000	17,866,843	18,779,000	0.65%
3M CO	207,600	11,112,412	18,686,076	0.64%
UNITED PARCEL SERVICE INC	246,000	15,853,714	18,491,820	0.64%
QUALCOMM INC	250,000	16,765,376	18,245,000	0.63%
AMERICAN EXPRESS CO	355,000	5,836,063	18,239,900	0.63%
ORACLE CORP	1,497,000	21,403,572	17,859,210	0.62%
MORGAN STANLEY	331,000	16,321,232	17,466,870	0.60%
PROCTER + GAMBLE CO	320,000	13,413,874	17,420,800	0.60%
EMERSON ELECTRIC CO	273,000	9,794,277	17,349,150	0.60%
GOLDMAN SACHS GROUP INC	180,000	15,936,058	16,948,800	0.58%
OMNICOM GROUP	219,000	14,504,141	16,619,910	0.57%
HOME DEPOT INC	470,000	17,018,481	16,544,000	0.57%
MEDTRONIC INC	338,000	15,353,608	16,467,360	0.57%
COMCAST CORP	570,000	14,407,610	15,977,100	0.55%
MELLON FINANCIAL CORP	540,000	24,343,674	15,838,200	0.55%
ANHEUSER BUSCH COS INC	290,000	14,996,064	15,660,000	0.54%
COSTCO WHOLESALE CORP	380,000	13,464,237	15,606,600	0.54%
UNITEDHEALTH GROUP INC	250,000	15,863,603	15,562,500	0.54%
DU PONT E I DE NEMOURS + CO	336,000	13,084,038	14,925,120	0.51%
CONOCOPHILLIPS	187,080	11,179,840	14,272,333	0.49%
FEDERAL NATIONAL MTG ASSN	200,000	12,946,028	14,272,000	0.49%
WYETH	393,000	22,115,523	14,210,880	0.49%
FIRST DATA CORP	316,000	11,457,313	14,068,320	0.48%
INTUIT	363,000	16,414,231	14,004,540	0.48%
FEDERAL HOME LN MTG CORP	220,000	11,809,904	13,926,000	0.48%

<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
BEST BUY CO INC	271,000	9,790,297	13,750,540	0.47%
SCHLUMBERGER LTD	200,000	11,028,293	12,702,000	0.44%
BRISTOL MYERS SQUIBB CO	509,000	20,882,003	12,470,500	0.43%
MERRILL LYNCH + CO INC	230,000	13,182,101	12,415,400	0.43%
EMC CORP	1,083,000	17,819,020	12,346,200	0.43%
NEXTEL COMMUNICATIONS INC	455,000	11,971,451	12,130,300	0.42%
HONEYWELL INTERNATIONAL INC	320,000	10,161,627	11,721,600	0.40%
BOSTON SCIENTIFIC CORP	270,000	8,206,093	11,556,000	0.40%
TIME WARNER INC	652,500	23,791,010	11,470,950	0.40%
LILLY ELI + CO	160,000	9,970,910	11,185,600	0.39%
COLGATE PALMOLIVE CO	190,000	9,896,352	11,105,500	0.38%
INTERNATIONAL PAPER CO	245,000	9,031,924	10,951,500	0.38%
WALGREEN CO	300,000	8,915,910	10,863,000	0.37%
AUTOMATIC DATA PROCESSING INC	248,600	7,255,669	10,411,368	0.36%
MARSH + MCLENNAN COS INC	226,400	9,220,651	10,274,032	0.35%
PEPSICO INC	180,000	8,239,207	9,698,400	0.33%
CATERPILLAR INC	121,000	5,777,158	9,612,240	0.33%
US BANCORP	340,000	9,618,844	9,370,400	0.32%
ALCOA INC	273,600	9,131,115	9,037,008	0.31%
MBNA CORP	350,000	6,538,820	9,026,500	0.31%
WACHOVIA CORP	200,000	7,308,200	8,900,000	0.31%
BED BATH + BEYOND INC	228,000	9,420,336	8,766,600	0.30%
LEXMARK INTERNATIONAL INC	89,800	5,501,094	8,668,394	0.30%
UNION PACIFIC CORP	143,800	6,340,672	8,548,910	0.29%
TERADYNE INC	352,000	8,803,320	7,990,400	0.28%
ECOLAB INC	250,000	6,311,180	7,925,000	0.27%
EXPRESS SCRIPTS INC	100,000	7,602,348	7,923,000	0.27%
AIR PRODS + CHEMS INC	150,000	7,393,593	7,867,500	0.27%
COMPUTER SCIENCES CORP	166,600	8,323,714	7,735,238	0.27%
BIOMET INC	168,900	4,684,533	7,505,916	0.26%
INGERSOLL RAND COMPANY LIMITED	109,000	4,392,684	7,445,790	0.26%
AMBAC FINANCIAL GROUP INC	100,600	5,231,081	7,388,064	0.25%
FOREST LABS INC	130,000	8,249,369	7,361,900	0.25%
ANADARKO PETE CORP	125,000	5,618,263	7,325,000	0.25%
SAP AKTIENGESSELLSCHAFT	174,000	5,812,429	7,274,940	0.25%
FISERV INC	180,000	6,590,097	7,000,200	0.24%
ALLTEL CORP	135,100	8,322,032	6,838,762	0.24%
MARRIOTT INTERNATIONAL INC	136,600	5,444,794	6,813,608	0.23%
FORTUNE BRANDS INC	90,000	3,907,110	6,788,700	0.23%
PAYCHEX INC	200,000	7,587,740	6,776,000	0.23%
GILEAD SCIENCES INC	100,000	5,422,980	6,700,000	0.23%
HALLIBURTON CO	220,000	6,168,468	6,657,200	0.23%
CLEAR CHANNEL COMMUNICATIONS	180,000	7,647,976	6,651,000	0.23%
CLOROX CO	120,200	5,125,881	6,464,356	0.22%
CARDINAL HEALTH INC	80,000	4,852,311	5,604,000	0.19%
TRIBUNE CO	120,000	5,888,912	5,464,800	0.19%
NABORS INDUSTRIES LTD	120,000	4,948,176	5,426,400	0.19%
PNC FINANCIAL SERVICES GROUP INC	100,000	5,464,460	5,308,000	0.18%
CITRIX SYSTEMS INC	250,000	5,358,705	5,090,000	0.18%
MYLAN LABS INC	250,000	5,696,850	5,062,500	0.17%
FRANKLIN RESOURCES INC	100,000	3,812,542	5,008,000	0.17%
WASHINGTON MUTUAL INC	125,000	5,233,863	4,830,000	0.17%
MCCORMICK + CO INC	140,000	3,586,193	4,760,000	0.16%
KNIGHT RIDDER INC	65,000	4,444,304	4,680,000	0.16%
SIEBEL SYSTEMS INC	400,000	4,458,280	4,272,000	0.15%
TARGET CORP	100,000	2,117,264	4,247,000	0.15%
XILINX INC	127,100	2,744,852	4,233,701	0.15%
MOTOROLA INC	220,000	4,261,598	4,015,000	0.14%

<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
SUNTRUST BANKS INC	60,000	4,221,450	3,899,400	0.13%
FIFTH THIRD BANCORP	70,000	4,021,598	3,764,600	0.13%
VISHAY INTERTECHNOLOGY INC	200,000	4,030,265	3,716,000	0.13%
KINDER MORGAN INC	60,000	3,541,578	3,557,400	0.12%
COMPASS BANCSHARES INC	80,000	3,117,868	3,440,000	0.12%
FLEXTRONICS INTERNATIONAL LTD	200,000	3,679,105	3,190,000	0.11%
<b>COMMON STOCK POOL TOTAL</b>	<b>49,304,026</b>	<b>1,635,260,778</b>	<b>1,941,940,158</b>	<b>66.91%</b>
BGI S & P 500 INDEX FUND A	1,956,193	544,162,011	596,835,085	20.56%
BGI MONEY MARKET FUND	38	38	38	0.00%
BGI CASH	1	1	1	0.00%
<b>BGI EQUITY INDEX FUND</b>	<b>1,956,232</b>	<b>544,162,050</b>	<b>596,835,124</b>	<b>20.56%</b>
DIMENSIONAL FUND ADVISORS INC	386,262	260,000,000	323,104,286	11.13%
<b>DFA SMALL CAP SUBTRUST</b>	<b>386,262</b>	<b>260,000,000</b>	<b>323,104,286</b>	<b>11.13%</b>
STATE STREET SPIFF	233,071	33,509,500	34,236,062	1.18%
STATE STREET SPIFF	41,999	6,128,374	6,169,238	0.21%
<b>TOTAL EQUITY FUTURES</b>	<b>275,070</b>	<b>39,637,874</b>	<b>40,405,300</b>	<b>1.39%</b>
<b>MDEP TOTAL</b>	<b><u>51,921,590</u></b>	<b><u>2,479,060,702</u></b>	<b><u>2,902,284,868</u></b>	<b><u>100.00%</u></b>

## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Asset Value for the state of Montana Board of Investments, Montana International Equity Pool, as of June 30, 2004, and 2003, and the related Statement of Changes in Net Asset Value and Statement of Investment Income and Distribution for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net asset value of the state of Montana Board of Investments, Montana International Equity Pool, as of June 30, 2004, and 2003, and its changes in net asset value and investment income and distribution for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
MONTANA INTERNATIONAL EQUITY POOL FINANCIAL STATEMENTS**

**STATEMENT OF NET ASSET VALUE JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<b><u>Assets</u></b>		
Cash	\$ 1,803,332	\$ 868,216
Security lending cash collateral (Notes 3 and 4)	43,804,312	78,496,331
Broker receivable for securities sold but not settled (Note 2)	6,267,489	953,991
Dividend and interest receivable	1,057,520	1,018,759
Investments managed at fair value (cost of \$786,482,403 in 2004 and \$489,383,398 in 2003) (Notes 2 and 4)	<u>853,937,359</u>	<u>470,729,781</u>
<b>Total assets</b>	<b>\$ <u>906,870,012</u></b>	<b>\$ <u>552,067,078</u></b>
<b><u>Liabilities</u></b>		
Income due participants	\$ 926,817	\$ 771,639
Broker payable for securities purchased but not settled (Note 2)	3,743,798	25,723,955
Security lending obligations (Note 3)	43,804,312	78,496,331
Security lending expense payable	37,056	52,149
Due to other funds	0	35,604
Unrealized foreign exchange market gain (loss)	29,336	(16,024)
Administrative fee payable	<u>413,882</u>	<u>335,584</u>
<b>Total liabilities</b>	<b><u>48,955,201</u></b>	<b><u>105,399,238</u></b>
<b>Net asset value</b>	<b>\$ <u>857,914,811</u></b>	<b>\$ <u>446,667,840</u></b>
<b>Units Outstanding (Note 2)</b>	<b>7,966,121</b>	<b>5,356,076</b>
<b>Unit Value (Note 2)</b>	<b>\$ 107.70</b>	<b>\$ 83.39</b>

**STATEMENT OF CHANGES IN NET ASSET VALUE  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net asset value, beginning of year	\$ 446,667,840	\$ 429,150,556
Value of units purchased by participants (Note 2)	253,000,000	51,046,000
Value of units sold by participants	0	(53,957)
Changes in current value of investments managed	<u>158,246,971</u>	<u>(33,474,759)</u>
<b>Net asset value, end of year</b>	<b>\$ <u>857,914,811</u></b>	<b>\$ <u>446,667,840</u></b>

**STATEMENT OF INVESTMENT INCOME AND DISTRIBUTION  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Investment income (Note 2)	\$ 9,158,659	\$ 9,960,157
Security lending income	716,276	1,042,890
Security lending expense	(447,343)	(671,198)
Administrative expenses (Note 2)	(2,280,171)	(1,785,948)
Income due participants, beginning of year	<u>771,639</u>	<u>864,830</u>
<b>Income available for distribution</b>	<b>7,919,060</b>	<b>9,410,731</b>
<b>Distribution (Note 2)</b>	<b><u>6,992,243</u></b>	<b><u>8,639,092</u></b>
<b>Income due participants, end of year</b>	<b>\$ <u>926,817</u></b>	<b>\$ <u>771,639</u></b>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS  
MONTANA INTERNATIONAL EQUITY POOL**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2004 and 2003**

**1. HISTORY AND ORGANIZATION**

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The Montana International Equity Pool (MTIP) was created by the Board to allow qualifying funds, per section 17-6-201, MCA, the opportunity to participate in the international equity market via a diversified pool. MTIP, approved by the Board in June 1996, consists of one pool investing in one or more separate funds. On January 3, 1997, the MTIP was funded by the Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds. Currently, the MTIP has investments with four externally managed funds, Pyrford International, Schroder Investment Management NA, Nomura Asset Management U.S.A. Inc. and Barclays Global Investors.

In fiscal year 2003, the Board funded external managers, Pyrford International, \$27 million, and Schroder Investment Management NA, \$9 million, for a total active investment funding of \$36 million. In May 2003, the Board funded the Barclays Global Investors (BGI) MSCI Europe Index Fund with an initial \$15 million investment.

On July 1, 2003, the Board funded MTIP with a \$35 million purchase in the State Street Stock Performance Index Futures Fund (SPIFF). SPIFF shares were subsequently sold to fund \$25 million to the BGI MSCI Europe Index Fund on July 3, 2003.

In August 2003, the Board invested in the BGI All Country Pacific Index Strategy Fund with an initial funding of \$15 million.

On October 30, 2003, the Board voted to retain Schroder Investment Management NA, hire Nomura Asset Management U.S.A, Inc. and terminate SG Yamaichi Asset Management, Co. as active managers for the Board's Pacific Basin equity mandate. Schroder Investment Management NA was originally selected by the Board in October 1996.

SG Yamaichi Asset Management, Co. ceased equity trading in the Pacific Basin on October 31, 2003. The MTIP investment in SG Yamaichi Asset Management, Co. of \$105 million was transferred to Nomura Asset Management U.S.A, Inc. Upon transition, Nomura Asset Management U.S.A, Inc. began equity trading in the Pacific Basin on December 1, 2003.

The internally managed fund, BOI Internal International, was closed in January 2004. The BOI Internal International assets were sold and restructured by Barclays Global Investors for an investment of \$190.4 million in the BGI MSCI Europe Index Fund. The sale and restructure of the BOI Internal International fund generated a gain of \$25.7 million.

In fiscal year 2004, the Board funded \$15 million to BOI Internal International, \$170 million to the Barclays Global Investors (BGI) MSCI Europe Index Fund, \$40 million to the BGI All Country Pacific Index Strategy Fund and \$28 million to the State Street SPIFF account.

Schroder Investment Management NA, Nomura Asset Management U.S.A, Inc. from December 2003, SG Yamaichi Asset Management Co. through October 2003, and the BGI All Country Pacific Index Strategy Fund are authorized to invest in 12 Pacific Basin countries. These countries are listed as follows:

## Pacific Basin Countries

Australia	Indonesia	Malaysia	Singapore
China	Japan	New Zealand	Taiwan
Hong Kong	Korea	Philippines	Thailand

As approved by the Board, the BOI Internal International fund, Pyrford International and the BGI MSCI Europe Index Fund may invest in 16 European countries. These countries are listed as follows:

## European Countries

Austria	France	Italy	Spain
Belgium	Germany	Netherlands	Sweden
Denmark	Greece	Norway	Switzerland
Finland	Ireland	Portugal	United Kingdom

In March 2003, the Board voted to liquidate all BOI Internal International holdings in France. On October 30, 2003, the Board voted to add France to the list of approved countries for the BOI Internal International portfolio.

In December 2003, the Board voted to retain Pyrford International, as an external investment manager for Europe. Pyrford International was originally selected by the Board in August 1998.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Investments

MTIP investments are purchased in accordance with the statutorily mandated “Prudent Expert Principle”. The MTIP portfolio includes equity investments in six funds - BOI Internal International through January 2004, Pyrford International, Schroder Investment Management NA, Nomura Asset Management U.S.A, Inc. from December 2003, SG Yamaichi Asset Management Co. through October 2003, the BGI MSCI Europe Index Fund and the BGI All Country Pacific Index Strategy Fund. The six funds may invest in securities of foreign-based corporations listed on legal and recognized foreign exchanges as well as domestic exchanges. Security types may include ordinary common shares, preferred shares, convertible securities, American Depositary Receipts (ADR’s), Global Depositary Receipts (GDR’s), and other global securities, as appropriate.

Common stock represents ownership units (shares) of a public corporation. Common stock owners are entitled to vote on director selection and other important matters as well as receive dividends on their holdings. Preferred stock pays a stipulated dividend and has a claim prior to that of common stock upon the earnings of a corporation. Convertible securities are securities carrying the right to exchange, or “convert” the instrument for other securities of the issuer or of another issuer. ADR’s are receipts issued by a US depositary bank representing shares of a foreign stock or bonds held abroad by the foreign sub-custodian of the American depositary bank. GDR’s are receipts issued by non-US bank depositaries, which represent shares of a foreign stock or bonds.

### Broker Receivable/Payable

MTIP security transactions are recorded as of the trade date rather than settlement date. Because of this generally accepted practice, the MTIP portfolio at June 30 may include receivables from brokers for securities sold, but not delivered, and payables to brokers for securities purchased, but not received.

### Valuation and Foreign Currency

Investments are presented in the statement of Net Asset Value at current US dollar value. The MTIP’s fair value is derived from the Net Asset Value per Share, as separately calculated, for four funds - BOI Internal International through January 2004, Pyrford International, Schroder Investment Management NA, Nomura



Asset Management U.S.A, Inc. from December 2003, and SG Yamaichi Asset Management Co. through October 2003. Each fund's Net Asset Value per Share represents the per unit ownership of the fund's Net Assets. The Net Assets are the excess of the valued securities, cash, receivables and other assets over the fund's liabilities. Each fund's Net Assets are reported at current US dollar value after conversion, by the custodial bank, State Street Bank and Trust, from the foreign currency amounts. The MTIP's fair value also includes the per share fair value of the BGI MSCI Europe Index Fund, the BGI All Country Pacific Index Strategy Fund and the State Street Bank SPIFF account.

State Street Bank, as custodian, is responsible for reporting the foreign currency transactions in both the local and base or functional (US dollar) currency. The four funds' cash, receivables, fair value of investment securities, other assets and liabilities are translated into US dollars at the Interactive Data Control (IDC) 11:00 a.m. Eastern Standard Time (EST) exchange rate as of the balance sheet date. Purchases and sales of investment securities, income and expenses are converted into US dollars using the Reuters noon EST exchange rate on the transaction date.

Currency exposures may be hedged, partially or fully, at the discretion of the manager to preserve the US dollar value of investments made. Currency speculation, such as over-hedging, reverse hedging or other trading activity not specifically aimed at preserving the US dollar value of investments, is not authorized.

Fair values for the funds holding the publicly traded securities are determined by reference to market prices supplied to the Board by the Board's custodial bank, State Street Bank, their primary pricing service, IDC and Barclays Global Investors. Equity investments, traded on a national security exchange, are stated at the last reported sales price on valuation day, while equity securities traded in the over-the-counter market are stated at the last quoted bid price.

#### **Participant Units**

The Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds sold units in the Short Term Investment Pool at the start up date and were issued units in MTIP at an initial unit value of \$100. Unit values thereafter are calculated weekly and once a month at the close of the last business day of the month, based upon the fair value of the MTIP equity holdings, other assets and liabilities. Based on the investment officers' decision, participants may then buy or sell units on the first business day of each month. All participant buys or sells occur after distribution of accumulated income.

#### **Investment Income and Distribution**

Investment Income represents the monthly income distributions to the MTIP from the investment manager funds. The funds' income distributions include dividends accrued as of the ex-dividend date, interest, tax refunds and securities lending income, and related income currency gains/losses. Income currency gains/losses result from the difference between the amount of dividend, interest and foreign withholding taxes accrued for the fund in US dollars and the amount received or paid in equivalent US dollars.

Realized gains/losses from the sale of securities and related foreign exchange transactions are retained by each fund. Realized foreign exchange gains/losses arise from sales and maturities of portfolio securities, sales of foreign currencies, and currency gains/losses realized between the trade and settlement dates.

The fiscal year 2004 administrative expense of \$2,280,171 represents \$1,762,323 in quarterly fees accrued and paid to the external managers per their contracts and \$517,848 in monthly charges accrued and paid to the Board of Investments.

The fiscal year 2003 administrative expense of \$1,785,948 represents \$1,358,700 in quarterly fees accrued and paid to the external managers per their contracts, and \$427,248 in monthly charges accrued and paid to the Board of Investments.

As described above, the Board of Investments fee includes costs for the custodial bank contract. Administrative expenses incurred by the Board are charged daily to MTIP based on the Board's expenses applicable to MTIP.

The MTIP Income Available for Distribution is distributed at least monthly to the retirement fund participants, net of external manager fees and administrative expenses, on the first business day of the following month.

### **3. SECURITIES LENDING**

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 105 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received US dollar and foreign currency cash, US government securities, sovereign debt of foreign countries, and irrevocable bank letters of credit as collateral. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine.

As of June 30, 2004, the carrying and fair values of the underlying securities on loan for MTIP were \$33,107,687 and \$41,747,542, respectively. The collateral provided for the securities on loan totaled \$43,804,312 in cash collateral.

As of June 30, 2003, the carrying and fair values of the underlying securities on loan for MTIP were \$75,267,314 and \$74,813,847, respectively. The collateral provided for the securities on loan totaled \$78,496,331 in cash collateral.

### **4. INVESTMENT RISK CATEGORIES**

State of Montana investments are categorized below to give an indication of the level of risk assumed at June 30, 2004 and June 30, 2003. Category 1 includes investments that are insured or registered, or securities that are held by the Board or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

**Risk as of June 30, 2004**

**C a t e g o r y 1**

<b><u>Security Investment Type</u></b>	<b>Securities Not <u>On Loan</u></b>	<b>On Loan for Securities <u>Collateral*</u></b>	<b>Not <u>Categorized*</u></b>	<b>Carrying <u>Amount</u></b>	<b>Fair <u>Value</u></b>
BGI MSCI Europe Index	\$ 375,433,656	\$ 0	\$ 0	\$ 375,433,656	\$ 389,187,569
BOI MSCI Pacific Index	40,005,322	0	0	40,005,322	46,167,852
BGI Cash and Money Market	781	0	0	781	781
SPIFF	31,374,029	0	0	31,374,029	31,685,217
Schroder Investment Mgmt.	118,527,086	0	13,211,062	131,738,148	150,236,944
Pyford International	100,537,724	0	19,179,273	119,716,997	133,028,120
Nomura	<u>87,496,118</u>	<u>0</u>	<u>717,352</u>	<u>88,213,470</u>	<u>103,630,876</u>
<b>Total Investment</b>	<b>\$ <u>753,374,716</u></b>	<b>\$ <u>0</u></b>	<b>\$ <u>33,107,687</u></b>	<b>\$ <u>786,482,403</u></b>	<b>\$ <u>853,937,359</u></b>
Securities Lending Collateral Investment Pool			<u>43,804,312</u>	<u>43,804,312</u>	<u>43,804,312</u>

\* At June 30, 2004, the underlying securities with fair values of \$41,747,542 were loaned for cash collateral under a securities lending agreement with the state's agent.

**Risk as of June 30, 2003**

**C a t e g o r y 1**

<b><u>Security Investment Type</u></b>	<b>Securities Not <u>On Loan</u></b>	<b>On Loan for Securities <u>Collateral*</u></b>	<b>Not <u>Categorized*</u></b>	<b>Carrying <u>Amount</u></b>	<b>Fair <u>Value</u></b>
BGI MSCI Europe Index	\$ 40,000,000	\$ 0	\$ 0	\$ 40,000,000	\$ 41,094,723
BOI Internal International	114,468,681	0	18,460,365	132,929,046	132,270,563
Pyford International	107,654,491	0	15,172,082	122,826,573	109,475,945
Schroder Investment Mgmt.	98,495,947	0	21,876,365	120,372,312	113,041,041
SG Yamaichi Asset Mgmt.	<u>53,496,965</u>	<u>0</u>	<u>19,758,502</u>	<u>73,255,467</u>	<u>74,847,509</u>
<b>Total Investment</b>	<b>\$ <u>414,116,084</u></b>	<b>\$ <u>0</u></b>	<b>\$ <u>75,267,314</u></b>	<b>\$ <u>489,383,398</u></b>	<b>\$ <u>470,729,781</u></b>
Securities Lending Collateral Investment Pool			<u>78,496,331</u>	<u>78,496,331</u>	<u>78,496,331</u>

\* At June 30, 2003, the underlying securities with fair values of \$74,813,847 were loaned for cash collateral under a securities lending agreement with the state's agent.

The MTIP, through the above funds, has significant investments in 20 foreign countries. Future economic and political developments in these countries could adversely affect the liquidity or value, or both, of the securities held by the above funds in which MTIP is invested.

## 5. SUBSEQUENT EVENT

On October 21, 2004, the Board authorized the investment in the Dimensional Fund Advisors International Small Companies portfolio. On November 1, 2004, the Board made an initial investment of \$10 million in this fund.

## 6. YEAR END PORTFOLIO

The combined investment portfolios for the five funds, as of June 30, 2004 are listed below by country. The

percent is based on the total fair value of each security/country to the combined total portfolio fair value.

<u>Country</u>	<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
AUSTRALIA	ALUMINA LIMITED	98,899	401,269	362,972	0.04%
AUSTRALIA	AMCOR LIMITED	169,567	699,197	822,968	0.10%
AUSTRALIA	AUSTRALIA / NEW ZEALAND BANK GRP	70,797	787,862	899,577	0.11%
AUSTRALIA	AUSTRALIA GAS + LIGHT	33,535	255,663	282,752	0.03%
AUSTRALIA	BHP BILLITON LTD	467,510	2,471,293	4,077,377	0.48%
AUSTRALIA	BRAMBLES INDUSTRIES LTD	230,070	1,183,916	961,601	0.11%
AUSTRALIA	COCA COLA AMATIL	103,100	311,625	497,709	0.06%
AUSTRALIA	COMMONWEALTH BK OF AUSTRALIA	94,431	1,507,522	2,142,487	0.25%
AUSTRALIA	CSL LIMITED	15,725	182,854	244,275	0.03%
AUSTRALIA	FOODLAND ASSOC	30,786	421,713	385,188	0.05%
AUSTRALIA	FOSTERS GROUP	343,735	1,109,536	1,129,521	0.13%
AUSTRALIA	INSURANCE AUSTRALIA GROUP	145,301	455,415	504,994	0.06%
AUSTRALIA	LEND LEASE CORP	104,693	723,430	748,985	0.09%
AUSTRALIA	MACQUARIE INFRASTRUCTURE GRP	317,100	701,000	728,943	0.09%
AUSTRALIA	MAYNE GROUP LTD	90,051	228,098	213,447	0.02%
AUSTRALIA	NATIONAL AUSTRALIA BANK	120,746	2,547,062	2,508,480	0.29%
AUSTRALIA	NEWS CORPORATION	122,906	871,713	1,003,825	0.12%
AUSTRALIA	NEWS CORPORATION	197,500	1,660,489	1,744,495	0.20%
AUSTRALIA	PUBLISHING + BROADCASTING LTD	80,000	697,210	716,105	0.08%
AUSTRALIA	RINKER GROUP	116,507	510,749	651,921	0.08%
AUSTRALIA	RIO TINTO LIMITED	87,219	1,802,774	2,182,543	0.26%
AUSTRALIA	TABCORP HOLDINGS LTD	43,701	360,966	432,562	0.05%
AUSTRALIA	TELSTRA CORP	99,394	287,308	347,516	0.04%
AUSTRALIA	WESTFIELD TRUST	5,700	15,241	17,314	0.00%
AUSTRALIA	WESTFIELD TRUST	157,104	387,904	481,585	0.06%
AUSTRALIA	WESTPAC BANKING CORP	263,690	2,430,119	3,230,126	0.38%
AUSTRALIA	WOODSIDE PETROLEUM	82,040	678,569	951,866	0.11%
AUSTRALIA	WOOLWORTHS LTD	122,100	986,940	969,625	0.11%
<b>AUSTRALIA 28 ISSUE(S)</b>		<b>3,813,907</b>	<b>24,677,440</b>	<b>29,240,763</b>	<b>3.42%</b>
BELGIUM	DEXIA	203,340	2,495,673	3,364,553	0.39%
BELGIUM	DEXIA STRIPS	129,140	0	1,571	0.00%
<b>BELGIUM 2 ISSUE(S)</b>		<b>332,480</b>	<b>2,495,673</b>	<b>3,366,124</b>	<b>0.39%</b>
CHINA	AVICHINA INDUSTRY	1,300,000	266,635	151,673	0.02%
CHINA	CHINA OILFIELD SER	2,560,000	635,153	730,275	0.09%
CHINA	CHINA TELECOM CORP	2,962,000	902,722	1,034,828	0.12%
CHINA	FUJIAN ZIJIN MININ	906,000	324,299	307,820	0.04%
CHINA	HUANENG POWER INTL	282,000	200,120	251,279	0.03%
CHINA	PING AN INSURANCE	168,500	225,434	228,993	0.03%
CHINA	PING AN INSURANCE	349,500	467,319	474,974	0.06%
CHINA	ZHEJIANG EXPRESSWAY	582,000	217,274	414,126	0.05%
<b>CHINA 8 ISSUE(S)</b>		<b>9,110,000</b>	<b>3,238,955</b>	<b>3,593,967</b>	<b>0.42%</b>
FRANCE	AIR LIQUIDE(L )	3,363	451,101	556,048	0.07%
FRANCE	CNP ASSURANCES	41,300	1,633,955	2,396,310	0.28%
FRANCE	TOTAL SA	24,900	3,538,744	4,747,162	0.56%
FRANCE	VALEO	83,700	3,274,886	3,487,801	0.41%
FRANCE	VEOLIA ENVIRONNEMENT	87,900	1,752,729	2,480,021	0.29%
<b>FRANCE 5 SSUE(S)</b>		<b>241,163</b>	<b>10,651,415</b>	<b>13,667,342</b>	<b>1.60%</b>
GERMANY	HENKEL KGAA	6,900	396,625	589,153	0.07%
GERMANY	SCHERING AG	38,600	1,798,483	2,274,403	0.27%
<b>GERMANY 2 ISSUE(S)</b>		<b>45,500</b>	<b>2,195,108</b>	<b>2,863,556</b>	<b>0.34%</b>
HONG KONG	CATHAY PACIFIC AIR	53,808	92,859	101,411	0.01%
HONG KONG	CHEUNG KONG HOLDINGS	70,000	480,655	516,045	0.06%
HONG KONG	CHINA MERCHANTS HOLDINGS INTL	524,000	533,998	705,405	0.08%
HONG KONG	CHINA MOBILE	226,500	629,370	685,334	0.08%
HONG KONG	CHINA PETROLEUM + CHEMICAL	1,100,000	327,813	401,939	0.05%

<u>Country</u>	<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
HONG KONG	CLP HOLDINGS	152,736	706,442	836,164	0.10%
HONG KONG	CNOOC LTD	2,346,000	743,747	992,569	0.12%
HONG KONG	DENWAY MOTORS LTD	462,352	126,360	167,461	0.02%
HONG KONG	HANG SENG BANK	22,598	287,057	289,729	0.03%
HONG KONG	HENDERSON LAND DEVELOPMENT	218,000	913,169	939,101	0.11%
HONG KONG	HOPEWELL HIGHWAY	160,000	87,514	94,875	0.01%
HONG KONG	HUTCHISON WHAMPOA	101,112	805,167	690,306	0.08%
HONG KONG	JOHNSON ELECTRIC HOLDINGS	717,000	710,841	730,807	0.09%
HONG KONG	LI + FUNG	432,000	701,965	631,401	0.07%
HONG KONG	MOULIN INTERNATIONAL HOLDING	568,000	412,074	347,727	0.04%
HONG KONG	SUN HUNG KAI PROPS	206,520	1,601,357	1,694,574	0.20%
HONG KONG	SWIRE PACIFIC	203,500	1,020,457	1,317,569	0.15%
HONG KONG	TEXWINCA HOLDINGS	666,000	500,898	525,129	0.06%
HONG KONG	WHARF HOLDINGS	324,000	786,562	930,485	0.11%
HONG KONG	WING LUNG BANK	16,000	109,730	109,748	0.01%
<b>HONG KONG 20 ISSUE(S)</b>		<b>8,570,126</b>	<b>11,578,034</b>	<b>12,707,779</b>	<b>1.49%</b>
INDONESIA	BANK CENTRAL ASIA	1,513,000	353,420	301,715	0.04%
INDONESIA	TELEKOMUNIKASI IND	636,500	335,946	500,941	0.06%
<b>INDONESIA 2 ISSUE(S)</b>		<b>2,149,500</b>	<b>689,366</b>	<b>802,656</b>	<b>0.09%</b>
IRELAND	BANK OF IRELAND	273,400	3,305,418	3,652,301	0.43%
<b>IRELAND 1 SUE(S)</b>		<b>273,400</b>	<b>3,305,418</b>	<b>3,652,301</b>	<b>0.43%</b>
JAPAN	AISIN SEIKI CO	56,600	813,611	1,177,603	0.14%
JAPAN	AJINOMOTO CO INC	123,000	1,283,980	1,481,208	0.17%
JAPAN	ALPS ELECTRIC CO	36,000	480,252	510,970	0.06%
JAPAN	ASAHI GLASS CO	73,000	479,600	757,739	0.09%
JAPAN	ASAHI KASEI CORP	200,000	943,225	1,033,426	0.12%
JAPAN	BANK OF YOKOHAMA	182,000	785,634	1,137,552	0.13%
JAPAN	BRIDGESTONE CORP	207,000	2,785,497	3,887,910	0.46%
JAPAN	BROTHER INDUSTRIES	25,000	213,185	241,666	0.03%
JAPAN	C+S CO LTD	34,000	556,649	897,069	0.11%
JAPAN	CANON INC	37,000	1,848,864	1,949,778	0.23%
JAPAN	CANON SALES CO INC	26,000	202,301	359,998	0.04%
JAPAN	CENTRAL GLASS CO	76,000	446,881	642,224	0.08%
JAPAN	CITIZEN WATCH CO	51,000	370,744	576,487	0.07%
JAPAN	CREDIT SAISON CO	30,000	585,916	899,904	0.11%
JAPAN	DAI DAN CO	28,000	245,157	142,932	0.02%
JAPAN	DAICEL CHEM INDS	27,000	138,627	141,488	0.02%
JAPAN	DAIDO STEEL CO	189,000	310,343	509,900	0.06%
JAPAN	DAIICHI PHARM CO	21,200	320,027	377,895	0.04%
JAPAN	DAIKIN INDUSTRIES	42,000	877,132	1,125,429	0.13%
JAPAN	DAINIPPON SCREEN	33,000	128,816	194,357	0.02%
JAPAN	DAIWA SECURITIES GROUP INC	109,000	649,662	781,526	0.09%
JAPAN	DENKI KAGAKU KOGYO	220,000	656,793	778,636	0.09%
JAPAN	DOWA MINING CO	192,000	905,409	1,136,074	0.13%
JAPAN	EAST JAPAN RAILWAY	1,054	5,148,069	5,910,183	0.69%
JAPAN	FAST RETAILING CO	13,000	717,434	1,049,797	0.12%
JAPAN	FUJI HEAVY INDUSTRIES	204,000	887,293	1,141,781	0.13%
JAPAN	FUJI PHOTO FILM CO	141,000	4,222,513	4,414,100	0.52%
JAPAN	FUNAI ELECTRIC CO	9,200	1,128,316	1,384,739	0.16%
JAPAN	GLORY	7,000	76,276	103,670	0.01%
JAPAN	HISAMITSU PHARMACEUTICAL CO	9,000	103,814	166,263	0.02%
JAPAN	HITACHI METALS	37,000	145,301	201,335	0.02%
JAPAN	HITACHI TRANSPORT SYSTEM	135,000	759,476	1,073,913	0.13%
JAPAN	HONDA MOTOR CO	118,100	4,653,737	5,686,530	0.67%
JAPAN	ITO YOKADO CO	43,000	1,389,281	1,838,822	0.22%
JAPAN	ITOCHU CORP	229,000	565,836	1,026,201	0.12%
JAPAN	ITOCHU TECHNOLOGY SCIENCE	6,800	184,999	289,176	0.03%
JAPAN	JAPAN AIRPORT TERM	103,000	791,446	1,094,992	0.13%

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JAPAN	JFE HOLDING INC	79,300	1,352,558	1,939,984	0.23%
JAPAN	KAMIGUMI CO	111,000	747,109	805,003	0.09%
JAPAN	KANEKA CORP	93,000	697,885	880,438	0.10%
JAPAN	KDDI CORP	269	1,555,579	1,537,041	0.18%
JAPAN	KEIHIN CORP	51,200	487,279	660,222	0.08%
JAPAN	KEYENCE CORP	2,000	424,491	455,256	0.05%
JAPAN	KONICA MINOLTA HOLDINGS INC	50,500	526,990	695,532	0.08%
JAPAN	KURARAY CO	137,000	1,058,874	1,121,212	0.13%
JAPAN	KYORIN PHARMACEUTICALS	31,000	400,039	452,760	0.05%
JAPAN	MABUCHI MOTOR CO	15,200	1,166,318	1,126,303	0.13%
JAPAN	MARUI CO	77,100	1,176,934	1,038,693	0.12%
JAPAN	MATSUSHITA ELCTRIC IND	115,000	1,725,591	1,632,544	0.19%
JAPAN	MILLEA HOLDINGS INC	129	1,246,962	1,915,227	0.22%
JAPAN	MITSUBISHI CORP	122,000	1,141,212	1,185,172	0.14%
JAPAN	MITSUBISHI ELECTRIC CP	612,000	2,355,847	3,002,525	0.35%
JAPAN	MITSUBISHI ESTATE	61,000	645,515	756,945	0.09%
JAPAN	MITSUBISHI TOKYO FIN	330	3,137,414	3,048,150	0.36%
JAPAN	MITSUMI + CO	517,000	3,118,881	3,871,044	0.45%
JAPAN	MITSUMI FUDOSAN CO	90,000	763,490	1,076,592	0.13%
JAPAN	MITSUMI SUMITOMO INSURANCE CO	89,000	498,854	834,286	0.10%
JAPAN	MITSUMI LTD	47,000	239,225	260,478	0.03%
JAPAN	MURATA MFG CO	53,200	2,837,293	3,032,617	0.36%
JAPAN	NAMCO	14,400	375,419	402,981	0.05%
JAPAN	NEC SYS INT+CONST	15,000	109,160	148,978	0.02%
JAPAN	NGK SPARK PLUG CO	143,000	1,115,588	1,372,139	0.16%
JAPAN	NICHICON CORP	18,400	1,108,388	248,205	0.03%
JAPAN	NINTENDO CO	8,000	671,005	925,511	0.11%
JAPAN	NIPPON CABLE SYS	16,000	142,971	229,043	0.03%
JAPAN	NIPPON ELEC GLASS	51,000	908,142	1,068,087	0.13%
JAPAN	NIPPON OIL CORP	179,000	894,444	1,124,633	0.13%
JAPAN	NIPPON SUISAN	59,000	118,217	156,477	0.02%
JAPAN	NIPPON TEL+TEL CP	635	4,285,776	3,389,908	0.40%
JAPAN	NIPPON TV NETWORK	6,750	1,297,009	1,107,318	0.13%
JAPAN	NIPPON UNIPAC HOLD	434	2,183,831	2,271,127	0.27%
JAPAN	NIPPON YUSEN KK	108,000	391,720	496,813	0.06%
JAPAN	NIPPON ZEON CO	41,000	320,274	296,593	0.03%
JAPAN	NISSAN MOTOR CO	282,000	2,986,822	3,128,319	0.37%
JAPAN	NISSIN CO LTD	50,200	148,262	206,135	0.02%
JAPAN	NITORI CO	1,000	54,757	62,554	0.01%
JAPAN	NITTO DENKO CORP	18,600	939,508	951,180	0.11%
JAPAN	NOMURA HOLDINGS	139,000	1,920,476	2,057,325	0.24%
JAPAN	NTN CORP	99,000	421,349	499,776	0.06%
JAPAN	NTT DOCOMO	560	1,382,919	1,000,779	0.12%
JAPAN	OMRON CORP	76,100	1,283,834	1,781,932	0.21%
JAPAN	ONO PHARMACEUTICAL	10,900	401,901	511,381	0.06%
JAPAN	ORIX CORP	11,000	667,464	1,257,488	0.15%
JAPAN	PARIS MIKI INC	9,000	141,089	202,067	0.02%
JAPAN	PROMISE CO	36,200	1,923,630	2,415,213	0.28%
JAPAN	RICOH CO	166,000	2,926,408	3,529,487	0.41%
JAPAN	ROHM CO	37,600	4,909,328	4,496,602	0.53%
JAPAN	SANKEN ELECTRIC CO	22,000	164,792	286,506	0.03%
JAPAN	SANKYO CO	36,000	629,237	778,636	0.09%
JAPAN	SANKYO CO	23,100	762,364	942,079	0.11%
JAPAN	SANKYO TATETAMA HO	87,000	288,308	265,746	0.03%
JAPAN	SANYO CHEMICAL IND	47,000	309,450	348,467	0.04%
JAPAN	SANYO SHOKAI	55,000	357,116	357,127	0.04%
JAPAN	SEIKO CORPORATION	19,000	90,125	153,258	0.02%
JAPAN	SHIMACHU CO	12,500	292,539	338,950	0.04%

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JAPAN	SHIMADZU CORP	59,000	295,747	301,084	0.04%
JAPAN	SHIMANO INC	25,100	484,440	596,827	0.07%
JAPAN	SHIN ETSU CHEM CO	41,400	1,509,917	1,479,723	0.17%
JAPAN	SHOWA DENKO KK	338,000	697,275	843,879	0.10%
JAPAN	SHOWA SHELL SEKIYU	163,100	1,066,058	1,466,353	0.17%
JAPAN	SMC CORP	11,400	1,094,886	1,232,828	0.14%
JAPAN	SOHGO SECURITY SER	30,200	379,469	394,399	0.05%
JAPAN	SOMPO JAPAN INS	237,000	1,348,775	2,421,803	0.28%
JAPAN	SQUARE ENIX CO LTD	17,200	385,535	470,328	0.06%
JAPAN	STANLEY ELECTRIC	17,000	328,122	283,580	0.03%
JAPAN	SUMITOMO BAKELITE	89,000	498,910	623,159	0.07%
JAPAN	SUMITOMO ELEC INDS	328,000	2,790,541	3,344,093	0.39%
JAPAN	SUMITOMO MITSUI GR	197	1,332,409	1,347,624	0.16%
JAPAN	SUMITOMO TRUST+BKG	154,000	855,957	1,094,316	0.13%
JAPAN	TAIYO YUDEN CO	13,000	142,360	182,734	0.02%
JAPAN	TAKASHIMAYA CO	77,000	515,927	890,565	0.10%
JAPAN	TAKEDA PHARMACEUTICAL CO LTD	124,900	4,996,213	5,481,158	0.64%
JAPAN	TANABE SEIYAKU CO	28,000	230,812	249,925	0.03%
JAPAN	TDK CORP	7,300	457,081	552,782	0.06%
JAPAN	TEIJIN	94,000	345,992	351,482	0.04%
JAPAN	THK CO	11,700	226,992	220,957	0.03%
JAPAN	TIS INC	8,400	253,317	358,754	0.04%
JAPAN	TOHO CO	82,900	721,827	1,204,962	0.14%
JAPAN	TOKAI RUBBER INDS	3,000	39,343	39,920	0.00%
JAPAN	TOKYO ELECTRIC POWER	62,300	1,370,731	1,413,119	0.17%
JAPAN	TOKYO GAS CO	193,000	672,251	683,077	0.08%
JAPAN	TOKYO SEIMITSU CO	26,000	769,341	891,673	0.10%
JAPAN	TOSTEM INAX HOLDING	41,000	653,954	883,031	0.10%
JAPAN	TOYO SEIKAN KAISHA	17,000	188,170	291,353	0.03%
JAPAN	TOYO SUISAN KAISHA	39,000	402,797	511,820	0.06%
JAPAN	TOYOTA INDUSTRIES	39,200	732,205	941,245	0.11%
JAPAN	TOYOTA MOTOR CORP	173,500	4,893,257	7,028,090	0.82%
JAPAN	TOYS R US	9,000	154,576	218,117	0.03%
JAPAN	UNITED ARROWS LTD	10,000	195,374	242,809	0.03%
JAPAN	USHIO INC	8,000	136,548	143,985	0.02%
JAPAN	VICTOR CO OF JAPAN	73,000	628,087	825,168	0.10%
JAPAN	YAMAHA CORP	64,000	1,097,348	1,047,693	0.12%
JAPAN	YAMANOUCHI PHARMACEUTICAL	100,300	3,300,918	3,373,514	0.40%
JAPAN	YAMATO TRANSPORT	97,000	1,100,163	1,581,849	0.19%
JAPAN	YORK BENIMARU CO	21,600	498,263	641,378	0.08%
<b>JAPAN 135 ISSUE(S)</b>		<b>10,262,258</b>	<b>138,821,945</b>	<b>162,411,275</b>	<b>19.02%</b>
KOREA	CHEIL COMMUNICATION	1,700	266,761	230,982	0.03%
KOREA	HYUNDAI DEPARTMENT STORE	31,400	709,211	778,546	0.09%
KOREA	HYUNDAI MOTOR CO	25,449	888,709	978,977	0.11%
KOREA	KANGWON LAND INC	38,701	389,308	428,709	0.05%
KOREA	KOOKMIN BANK	28,460	859,362	884,218	0.10%
KOREA	KT + G CORPORATION	19,862	338,308	458,949	0.05%
KOREA	KT CORPORATION	4,069	160,486	136,103	0.02%
KOREA	LG CHEMICAL	18,650	835,300	631,082	0.07%
KOREA	POSCO	6,261	642,908	807,347	0.09%
KOREA	SAMSUNG ELECTRONIC	15,533	2,957,380	6,412,151	0.75%
KOREA	SAMSUNG FIRE + MAR	6,100	388,669	390,125	0.05%
KOREA	SEOUL SECURITIES	178,170	617,673	430,198	0.05%
KOREA	SHINHAN FINANCIAL	71,186	1,211,255	1,034,985	0.12%
KOREA	SHINSEGAE CO LTD	2,180	293,856	524,483	0.06%
KOREA	SK TELECOM	5,053	932,209	830,870	0.10%
<b>KOREA 15 SSUE(S)</b>		<b>452,774</b>	<b>11,491,394</b>	<b>14,957,725</b>	<b>1.75%</b>
MALAYSIA	BRITISH AMERICAN TOBACCO	8,482	82,114	112,721	0.01%

<u>Country</u>	<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
MALAYSIA	COMMERCE ASSET HOLDINGS	703,700	948,448	899,995	0.11%
MALAYSIA	GENTING BERHAD	174,922	768,525	704,291	0.08%
MALAYSIA	IOI CORP	332,100	628,842	712,267	0.08%
MALAYSIA	LAFARGE MALAYAN CEMENT BHD	1,975,400	497,505	423,671	0.05%
MALAYSIA	MALAYAN BK BHD	404,500	984,856	1,075,118	0.13%
MALAYSIA	MALAYSIA INT SHIP	60,200	184,089	190,105	0.02%
MALAYSIA	MAXIS COMMUN BHD	74,900	143,693	173,453	0.02%
MALAYSIA	PLUS EXPRESSWAYS B	220,000	148,127	130,263	0.02%
MALAYSIA	PUBLIC BK BHD	135,900	209,673	236,037	0.03%
MALAYSIA	TANJONG	100,800	286,033	331,579	0.04%
MALAYSIA	TELEKOM MALAYSIA	255,000	689,505	691,184	0.08%
<b>MALAYSIA 12 ISSUE(S)</b>		<b>4,445,904</b>	<b>5,571,410</b>	<b>5,680,686</b>	<b>0.67%</b>
NETHERLANDS	AEGON NV	197,523	3,188,777	2,381,535	0.28%
NETHERLANDS	REED ELSEVIER NV	80,400	998,530	1,128,827	0.13%
NETHERLANDS	ROYAL DUTCH PETROLEUM CO	105,900	5,151,755	5,434,608	0.64%
NETHERLANDS	TPG NV	102,900	1,851,548	2,351,130	0.28%
NETHERLANDS	WOLTERS KLUWER	68,804	1,514,082	1,248,959	0.15%
<b>NETHERLANDS 5 ISSUE(S)</b>		<b>555,527</b>	<b>12,704,693</b>	<b>12,545,059</b>	<b>1.47%</b>
NEW ZEALAND	CARTER HOLT HARVEY	217,958	263,655	285,367	0.03%
NEW ZEALAND	FLETCHER BUILDING	60,000	169,714	172,672	0.02%
NEW ZEALAND	TELECOM CORP OF NEW ZEALAND	188,700	494,021	704,624	0.08%
<b>NEW ZEALAND 3 ISSUE(S)</b>		<b>466,658</b>	<b>927,390</b>	<b>1,162,663</b>	<b>0.14%</b>
PHILIPPINES	BANK OF PHILIPPINES ISLANDS	240,000	176,212	183,957	0.02%
<b>PHILIPPINES 1 ISSUE(S)</b>		<b>240,000</b>	<b>176,212</b>	<b>183,957</b>	<b>0.02%</b>
SINGAPORE	CITY DEVELOPMENTS	38,000	122,086	119,212	0.01%
SINGAPORE	DBS GROUP HOLDINGS	206,266	1,626,318	1,724,609	0.20%
SINGAPORE	KEPPEL LAND LTD	134,000	129,157	125,336	0.01%
SINGAPORE	MOBILEONE	692,000	523,148	602,630	0.07%
SINGAPORE	OVERSEAS CHINESE BANK	28,000	188,157	196,828	0.02%
SINGAPORE	SEMBCORP INDUSTRIES	717,000	566,412	557,798	0.07%
SINGAPORE	SINGAPORE AIRLINES	33,000	225,923	214,721	0.03%
SINGAPORE	SINGAPORE LAND	2,000	4,881	5,136	0.00%
SINGAPORE	SINGAPORE PRESS HD	86,768	216,479	209,699	0.02%
SINGAPORE	SINGAPORE TECH ENG	99,000	114,232	119,631	0.01%
SINGAPORE	SINGAPORE TELECOMM	133,000	139,418	173,851	0.02%
SINGAPORE	UNITED OVERSEAS BANK	213,576	1,477,988	1,661,896	0.19%
SINGAPORE	VENTURE CORP LTD	20,888	189,824	218,430	0.03%
<b>SINGAPORE 13 ISSUE(S)</b>		<b>2,403,498</b>	<b>5,524,022</b>	<b>5,929,777</b>	<b>0.69%</b>
SPAIN	BBVA (BILB VIZ ARG)	343,700	3,639,249	4,591,426	0.54%
SPAIN	ENAGAS SA	142,200	1,186,527	1,541,498	0.18%
SPAIN	ENDESA SA	260,800	3,416,584	5,026,069	0.59%
SPAIN	TELEFONICA SA	476,259	5,570,854	7,040,203	0.82%
<b>SPAIN 4 ISSUE(S)</b>		<b>1,222,959</b>	<b>13,813,214</b>	<b>18,199,196</b>	<b>2.13%</b>
SWITZERLAND	NESTLE SA	24,330	5,321,294	6,488,518	0.76%
SWITZERLAND	NOVARTIS AG	185,600	7,185,530	8,187,799	0.96%
SWITZERLAND	ROCHE HOLDINGS AG	43,110	3,669,393	4,268,317	0.50%
SWITZERLAND	SWATCH GROUP	7,000	744,771	911,051	0.11%
SWITZERLAND	SWISS REINSURANCE	96,600	7,250,055	6,274,681	0.73%
SWITZERLAND	SWISSCOM AG	1,700	529,272	561,961	0.07%
SWITZERLAND	ZURICH FINANCIAL SERVICES GROUP	16,790	4,152,014	2,651,088	0.31%
<b>SWITZERLAND 7 ISSUE(S)</b>		<b>375,130</b>	<b>28,852,328</b>	<b>29,343,415</b>	<b>3.44%</b>
TAIWAN	ACER INC	115,613	843,512	812,759	0.10%
TAIWAN	ADVANTECH	60,000	136,341	122,249	0.01%
TAIWAN	CATHAY FINANCIAL HOLDINGS LTD	90,000	152,868	161,861	0.02%
TAIWAN	CATHAY FINANCIAL HOLDINGS LTD	83,280	1,248,790	1,497,708	0.18%
TAIWAN	CHINA STEEL	4,000	46,749	75,000	0.01%
TAIWAN	CHINA STEEL	34,128	398,862	639,900	0.07%
TAIWAN	CHINA TRUST FINANCE	972,000	1,156,678	1,083,744	0.13%



<u>Country</u>	<u>Security Name</u>	<u>Shares</u>	<u>Carrying Value</u>	<u>Fair Value</u>	<u>% of Total</u>
TAIWAN	COMPAL ELECTRONIC	30,876	185,370	168,274	0.02%
TAIWAN	DELTA ELECTRONICS	147,000	183,106	184,515	0.02%
TAIWAN	FORMOSA PLASTIC	812,500	1,267,965	1,147,562	0.13%
TAIWAN	FUBON FINANCIAL HOLDING CO LTD	41,200	414,060	358,852	0.04%
TAIWAN	HON HAI PRECISION	67,000	298,885	248,960	0.03%
TAIWAN	HON HAI PRECISION IND LTD	179,035	1,409,821	1,342,763	0.16%
TAIWAN	MEDIA TEK INCORP	87,000	831,438	693,103	0.08%
TAIWAN	MERRY ELECTRONICS	97,000	236,006	222,159	0.03%
TAIWAN	QUANTA COMPUTER INC	47,300	560,505	496,650	0.06%
TAIWAN	TAIWAN SECOM CO	280,000	280,109	280,666	0.03%
TAIWAN	TAIWAN SEMICON MAN	1,154,556	1,872,093	1,661,537	0.19%
TAIWAN	UNITED MICROELECTRONICS CORP	78,158	265,112	336,861	0.04%
<b>TAIWAN 19 ISSUE(S)</b>		<b>4,380,646</b>	<b>11,788,270</b>	<b>11,535,123</b>	<b>1.35%</b>
THAILAND	BANGKOK BANK	97,600	198,245	224,368	0.03%
THAILAND	BANGKOK BANK	449,100	1,208,165	1,081,970	0.13%
THAILAND	KASIKORNBANK PCL	253,100	253,804	312,584	0.04%
THAILAND	LAND + HOUSES	2,736,600	827,860	652,607	0.08%
THAILAND	PTT EXPLORATION + PRD	65,800	305,832	431,264	0.05%
THAILAND	SIAM CEMENT CO	79,900	381,947	453,333	0.05%
THAILAND	TRUE CORP PUBLIC CO LTD RIGHTS	130,895	0	0	0.00%
<b>THAILAND 7 ISSUE(S)</b>		<b>3,812,995</b>	<b>3,175,853</b>	<b>3,156,126</b>	<b>0.37%</b>
UNITED KINGDOM	BOOTS GROUP	78,000	836,223	973,196	0.11%
UNITED KINGDOM	BP PLC	423,000	3,176,480	3,735,828	0.44%
UNITED KINGDOM	BRITISH SKY BROADCAST	242,600	3,100,552	2,736,520	0.32%
UNITED KINGDOM	COMPASS GROUP	628,000	3,942,074	3,832,324	0.45%
UNITED KINGDOM	EXEL	163,000	1,810,588	2,267,255	0.27%
UNITED KINGDOM	GALLAHER GROUP	364,900	3,410,070	4,410,537	0.52%
UNITED KINGDOM	GLAXOSMITHKLINE	211,000	4,754,206	4,270,357	0.50%
UNITED KINGDOM	HSBC HOLDINGS	98,800	1,274,380	1,488,376	0.17%
UNITED KINGDOM	LEGAL + GENERAL GP	3,038,240	5,375,177	5,234,355	0.61%
UNITED KINGDOM	RENTOKIL INITIAL	441,300	1,347,659	1,156,430	0.14%
UNITED KINGDOM	SCOTTISH + SOUTHERN ENERGY	259,000	2,469,196	3,200,981	0.37%
UNITED KINGDOM	SYNTHESE INC	7,890	456,113	899,311	0.11%
UNITED KINGDOM	TIBBETT + BRITTEN	94,700	887,865	1,159,234	0.14%
UNITED KINGDOM	TOMKINS	357,837	1,364,947	1,781,333	0.21%
UNITED KINGDOM	UNILEVER	131,064	1,139,300	1,285,873	0.15%
UNITED KINGDOM	UNITED UTILITIES	425,000	3,785,883	3,996,273	0.47%
UNITED KINGDOM	VODAFONE GROUP	2,219,544	4,251,857	4,860,359	0.57%
<b>UNITED KINGDOM 17 ISSUE(S)</b>		<b>9,183,875</b>	<b>43,382,569</b>	<b>47,288,544</b>	<b>5.54%</b>
UNITED STATES	BGI CASH	1	1	1	0.00%
UNITED STATES	BGI MSCI EQUITY INDEX FUND EUROPE	44,873,947	375,433,656	389,187,569	45.58%
UNITED STATES	BGI PACIFIC INDEX STRATEGY FUND	3,578,423	40,005,322	46,167,852	5.41%
UNITED STATES	BGI MONEY MARKET FUND	780	780	780	0.00%
<b>UNITED STATES 4 ISSUE(S)</b>		<b>48,453,151</b>	<b>415,439,759</b>	<b>435,356,202</b>	<b>50.98%</b>
<b>EQUITIES TOTAL 310 ISSUE(S)</b>		<b>110,791,451</b>	<b>750,500,468</b>	<b>817,644,235</b>	<b>95.74%</b>
UNITED STATES	STATE STREET SPIFF	215,706	31,374,029	31,685,217	3.71%
<b>EQUITY FUTURES TOTAL 1 ISSUE(S)</b>		<b>215,706</b>	<b>31,374,029</b>	<b>31,685,217</b>	<b>3.71%</b>
UNITED STATES	STATE STREET BANK + TRUST CO	4,607,906	4,607,906	4,607,906	0.54%
<b>CASH TOTAL 1 ISSUE(S)</b>		<b>4,607,906</b>	<b>4,607,906</b>	<b>4,607,906</b>	<b>0.54%</b>
<b>MTIP GRAND TOTAL 312 ISSUES</b>		<b>115,615,062</b>	<b>786,482,403</b>	<b>853,937,359</b>	<b>100.00%</b>

## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Asset Value for the state of Montana Board of Investments, Montana Private Equity Pool, as of June 30, 2004, and 2003, and the related Statement of Changes in Net Asset Value and Statement of Investment Income and Distribution for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net asset value of the state of Montana Board of Investments, Montana Private Equity Pool, as of June 30, 2004, and 2003, and its changes in net asset value and investment income and distribution for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
MONTANA PRIVATE EQUITY POOL FINANCIAL STATEMENTS**

**STATEMENT OF NET ASSET VALUE JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<b><u>Assets</u></b>		
Cash	\$ 0	\$ 0
Dividend receivable	1,172,950	199,575
Investments managed at fair value (carrying value of \$236,711,043 in 2004 and \$278,790,323 in 2003)(Notes 2 and 4)	<u>258,478,490</u>	<u>305,349,864</u>
<b>Total assets</b>	<b>\$ <u>259,651,440</u></b>	<b>\$ <u>305,549,439</u></b>
<b><u>Liabilities</u></b>		
Income due participants	\$ 5,273,616	\$ 7,361,863
<b>Total liabilities</b>	<b><u>5,273,616</u></b>	<b><u>7,361,863</u></b>
<b>Net asset value</b>	<b>\$ <u>254,377,824</u></b>	<b>\$ <u>298,187,576</u></b>
Units Outstanding (Note 2)	2,562,719	2,915,343
Unit Value (Note 2)	\$ 99.26	\$ 102.28

**STATEMENT OF CHANGES IN NET ASSET VALUE  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net asset value, beginning of year	\$ 298,187,576	\$ 188,041,797
Value of units purchased by participants (Notes 1 and 2)	0	121,828,726
Value of units sold by participants	(33,130,061)	(22,752,654)
Changes in fair value of investments managed	<u>(10,679,691)</u>	<u>11,069,707</u>
<b>Net asset value, end of year</b>	<b>\$ <u>254,377,824</u></b>	<b>\$ <u>298,187,576</u></b>

**STATEMENT OF INVESTMENT INCOME AND DISTRIBUTION  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

Net realized gains (Note 2)	\$ 76,554,966	\$ 4,309,426
Dividend/interest income	5,260,917	614,849
Administrative expenses	(2,681,882)	(3,056,068)
Income due participants, beginning of year	<u>7,361,863</u>	<u>9,309,822</u>
<b>Income available for distribution</b>	<b>86,495,864</b>	<b>11,178,029</b>
<b>Distribution (Note 2)</b>	<b><u>81,222,248</u></b>	<b><u>3,816,166</u></b>
<b>Income due participants, end of year</b>	<b>\$ <u>5,273,616</u></b>	<b>\$ <u>7,361,863</u></b>

**STATE OF MONTANA BOARD OF INVESTMENTS  
MONTANA PRIVATE EQUITY POOL**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2004 AND 2003**

**1. HISTORY AND ORGANIZATION**

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The Montana Private Equity Pool (MPEP) was established by the Board to allow retirement funds, per section 17-6-201, MCA, the opportunity to participate in the venture capital and leveraged buyout markets and other private equity investments via a diversified pool. The Board approved creation of the MPEP in April 2002. Effective May 1, 2002, the Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds transferred all their venture capital and leveraged buyout investments, at cost, totaling \$159,799,310, and cash of \$15,000,000 to the new pool. These investments were previously recorded in the All Other Funds financial statements for fiscal year 2001.

Given the complexity and specialization of private equity investment, the Board contracts with seven private equity managers to invest in venture capital, leveraged buyout and other private equity investments. The retained private equity managers include Adams Street Partners, formerly Brinson Partners; Kohlberg, Kravis, Roberts and Company, (KKR); Welsh Carson Anderson and Stowe; Madison Dearborn Partners; Lexington Partners; Oaktree Capital Management and ArcLight Energy Partners. According to Board policy, the external managers may not invest more than 30% of total private equity invested capital in non-US company partnerships unless the fund is a designated non-US fund. Total non-US exposure in MPEP is limited to 25% of total invested capital.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Investments**

Montana Private Equity Pool investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle". The MPEP portfolio includes venture capital, leveraged buyout, mezzanine, distressed debt, special situation and secondary investments. Venture capital represents private equity investments in early stage financing of rapidly growing companies with an innovative product or service. Leveraged buyouts (LBO's) permit an investment group to acquire a company by leveraging debt, as a financing technique, to establish a significant ownership position on behalf of the company's current management team. Mezzanine investments are the subordinated debt and/or equity of privately owned companies. The debt holder participates in equity appreciation through conversion features, such as rights, warrants, and/or options. Distressed debt represents the private and public debt of companies that appear unlikely to meet their financial obligations. This debt is attractive to investors, not for repayment of interest and principal, which are unlikely to be paid, but for the claim placed on the firm's value by unpaid creditors. Without undue principal risk, distressed debt investment managers seek capital appreciation through the sale of restructured debt obligations or newly issued securities. Special situation investments include the investment in the exploration for oil and/or gas reserves or in the development of proven reserves, investment in land to harvest timber, and investments that have a special component usually related to geographical, economic, or social issues. Secondary investments are investments in previously owned limited partnerships. These investments may be direct or via a general partner specializing in secondary investments. Private equity investments are long-term, by design, and extremely illiquid.

In creating the pool, the Board chose to securitize MPEP cash by investing in an equity derivative, the State Street Stock Performance Index Futures Fund (SPIFF). Portfolio cash is swept daily into SPIFF maintaining 100% equity exposure through holdings of stock index futures.

Investments are presented in the Statement of Net Asset Value at fair value. Because no recognized market exists for private equity investment, the MPEP investments, on valuation date, are stated at the fair value reported in the most recent external managers' valuation reports. Carrying value, parenthetically disclosed, represents the private equity security purchase price.

### Broker Receivable/Payable

MPEP security transactions are recorded as of trade date rather than settlement date. Because of this generally accepted practice, the MPEP portfolio at June 30 may include receivables from brokers for securities sold but not delivered, and payables to brokers for securities purchased but not received.

### Participant Units

The pension funds transferred all their venture capital and leveraged buyout investments, at cost, into the MPEP at the start-up date and were issued units according to the fair value of each participant's portfolio and cash contribution. The initial unit value as of May 1, 2002 was \$100. Although unit values are calculated at month end, the pool portfolio will be priced at least quarterly at the fair value reported in the external managers' valuation reports. Given the quarterly portfolio valuations, pool participant transactions will most likely occur on a quarterly basis. Based on the Investment Officer's decision, participants may buy, reinvest or sell units on the first business day of each month. All participant buys, reinvestments or sells occur after distribution of accumulated income.

### Investment Income and Distribution

The Statement of Investment Income and Distribution reports cash dividends, interest, net realized gains and losses, and miscellaneous income. The fiscal year 2004 net realized gains of \$76.6 million, as compared to fiscal year 2003 net realized gains of \$4.3 million, were generated from external investment manager decisions. These net realized gains were distributed to the MPEP participants. MPEP dividends are recorded on the ex-dividend date.

The MPEP Income Available for Distribution is distributed or reinvested, on behalf of the nine retirement fund participants, at least quarterly or as determined by the Investment Officer. Any cash distributions or reinvestments will occur on the first business day of the following month. The Income Available for Distribution is net of MPEP external manager fees and administrative expenses.

The fiscal year 2004 administrative expense of \$2,681,882 represents fees paid to the external managers of \$2,485,166 per their contracts and \$196,716 paid to the Board of Investments. The Board of Investments fee includes costs for the custodial bank contract. Administrative expenses incurred by the Board are charged daily to MPEP based on the Board's expenses applicable to MPEP.

The fiscal year 2003 administrative expense of \$3,056,068 represents fees paid to the external managers of \$2,816,202 per their contracts and \$239,866 paid to the Board of Investments. The Board of Investments fee includes costs for the custodial bank contract. Administrative expenses incurred by the Board are charged daily to MPEP based on the Board's expenses applicable to MPEP.

### Security Lending

Because there is no active security lending market for this asset class, MPEP does not participate in security lending.

## **3. COMMITMENTS**

Private equity investments, typically, represent a seven to ten year commitment characterized by capital calls occurring during the first five years with distributions to the investor over the remaining term of the investment. The original and remaining commitments and their respective carrying and fair values, as of June 30, 2004, are listed on the next page.

Commitments as of June 30, 2004

<u>Security Investment</u>	<u>Original Commitment Date</u>	<u>Original Commitment</u>	<u>Commitment Remaining</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Separate Account Partnerships	Jan 1988/Apr 1990	\$ 14,000,000	\$ 438,015	\$ 2,453,700	\$ 1,061,060
Venture Partnership Acquisition Fund II	April 1990	4,000,000	0	190,080	106,140
Brinson Venture Capital Fund III	March 1992	10,000,000	0	6,047,799	3,431,750
Brinson Venture Capital Fund IV	May 1999	15,000,000	891,667	14,108,333	9,500,241
Brinson Non-US Partnership Trust	January 1999	10,000,000	5,135,843	4,475,554	5,055,644
Brinson Partnership Trust 1996-2003	March 1996	103,940,867	47,646,861	48,680,492	43,212,407
Adams Street Partnership Trust 2002	August 2001	40,000,000	33,328,000	6,672,000	6,892,646
Adams Street Partnership Fund 2003	January 2003	20,000,000	18,100,000	1,900,000	1,808,400
Adams Street Partnership Fund 2004	October 2003	20,000,000	19,375,000	625,000	609,763
Adams Street Partners Fund V	August 2001	40,000,000	32,000,000	8,000,000	7,421,640
Adams Street Global Opportunities	September 2003	25,000,000	23,687,500	1,312,500	1,389,141
<b>Adams Street Total</b>		<b>301,940,867</b>	<b>180,602,886</b>	<b>94,465,458</b>	<b>80,488,832</b>
ArcLight Energy Partners Fund II	April 2004	25,000,000	22,923,700	2,076,300	2,076,300
<b>ArcLight Total</b>		<b>25,000,000</b>	<b>22,923,700</b>	<b>2,076,300</b>	<b>2,076,300</b>
KKR 1986, 1987 Fund	August 1987	25,300,000	0	13,562,439	4,941,054
KKR 1993 Fund	December 1990	25,000,000	0	4,006,575	3,835,923
KKR 1996 Fund	July 1996	100,000,000	0	50,311,901	55,540,666
KKR European Fund	August 1999	25,000,000	7,092,346	16,893,417	15,776,593
<b>KKR Total</b>		<b>175,300,000</b>	<b>7,092,346</b>	<b>84,774,332</b>	<b>80,094,236</b>
Lexington Capital Partners Fund V	May 2001	50,000,000	31,831,220	12,855,368	17,820,972
<b>Lexington Capital Partners Total</b>		<b>50,000,000</b>	<b>31,831,220</b>	<b>12,855,368</b>	<b>17,820,972</b>
Madison Dearborn Partners Fund IV	January 2001	22,509,475	14,297,794	6,005,793	5,595,706
Madison Dearborn Global Fund IV	September 2002	2,490,525	0	2,478,137	2,956,219
<b>Madison Dearborn Total</b>		<b>25,000,000</b>	<b>14,297,794</b>	<b>8,483,930</b>	<b>8,551,924</b>
Oaktree Capital Fund IVB	September 2002	75,000,000	0	1	32,498,809
<b>Oaktree Total</b>		<b>75,000,000</b>	<b>0</b>	<b>1</b>	<b>32,498,809</b>
Welsh Carson Anderson & Stowe Fund IX	September 2000	25,000,000	9,250,000	10,107,970	12,717,565
WCAS Capital Partners Fund IV	June 2004	25,000,000	25,000,000	0	0
<b>Welsh Carson Total</b>		<b>50,000,000</b>	<b>34,250,000</b>	<b>10,107,970</b>	<b>12,717,565</b>
<b>Total Private Equity Commitments</b>		<b>\$ 702,240,867</b>	<b>\$ 290,997,946</b>	<b>\$ 212,763,359</b>	<b>\$ 234,248,639</b>

#### 4. INVESTMENT RISK

Private equity investments are recognized as investments with a higher degree of risk with a higher return potential than traditional equity investments. Portfolio diversification of risk is to be achieved through multiple partnership relationships and investments diversified by time, financing stage, industry sector, investment size and geographical region. Private equity investments typically have a low correlation relative to other investment asset classes and should contribute to the reduction of portfolio risk and the enhancement of expected returns on a total investment portfolio basis.

#### 5. NOTICE OF LIABILITY

The Montana Board of Investments is a limited partner in the private equity partnership of O'Donnell & Masur L.P. O'Donnell & Masur L.P. invested in Gardiner Communications, Inc. All partners of O'Donnell & Masur L.P. received a Notice of Liability from the Internal Revenue Service claiming unpaid federal corporate taxes for Gardiner Communications, Inc. As a recipient of the distributions on the sale and dissolution of Gardiner Communications, Inc., the Board faces potential liability. O'Donnell & Masur L.P. has retained legal counsel to represent all partners receiving a Notice of Liability. On September 5, 2003, legal counsel filed a petition on the Montana Board of Investment's behalf in U.S. Tax Court to perfect the Board's right to contest this matter. On February 9, 2004, all partners of O'Donnell & Masur L.P. were informed that the Internal Revenue Service Appeals Officer had completed his review of the Gardiner Communications, Inc. matter. The Officer concluded "no additional taxes are due from Gardiner Communications, Inc. and thus, no transferee liability to the partners of O'Donnell & Masur, L.P."

## 6. YEAR END PORTFOLIO

The June 30, 2004 MPEP portfolio is listed below. The security type percentage is based on the fair value ratio of the specific security investment type to the total portfolio.

<u>Security Name</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
ALTA SUB DEBT PARTNERS III	96,605	96,605	139,533	0.05%
AUSTIN VENTURES III	249,043	249,043	129,656	0.05%
CAPITAL PARTNERS HOLDINGS II A	30,530	30,530	261,899	0.10%
GATEWAY VENTURE PARTNERS III	284,596	284,596	64,553	0.02%
INTERWEST PARTNERS IV	275,177	275,177	7,945	0.00%
MATRIX PARTNERS III L P	68,064	68,064	15,836	0.01%
NEW ENTERPRISE ASSOC V LP	253,338	253,338	54,329	0.02%
O DONNELL + MASUR L P	352,319	352,319	206,531	0.08%
SPROUT CAPITAL VI	275,956	275,956	32,170	0.01%
SUMMIT VENTURE II	128,881	128,881	3,199	0.00%
WCAS CAPITAL PARTNERS II	285,716	285,716	145,135	0.06%
WILLIAM BLAIR PARTNERS III LP	153,476	153,476	274	0.00%
<b>SEPARATE ACCOUNT PARTNERSHIPS</b>	<b>2,453,700</b>	<b>2,453,700</b>	<b>1,061,060</b>	<b>0.41%</b>
VENTURE PARTNERSHIP ACQUISITION II	190,080	190,080	106,140	0.04%
<b>VENTURE PARTNER ACQUISITION II</b>	<b>190,080</b>	<b>190,080</b>	<b>106,140</b>	<b>0.04%</b>
BRINSON VENTURE CAPITAL III SECONDARY	635,144	635,144	393,584	0.15%
BRINSON VENTURE PARTNERS III SECONDARY	2,629,109	2,629,109	1,322,495	0.51%
BRINSON VENTURE CAPITAL FUND III	555,556	555,556	393,584	0.15%
BRINSON VENTURE PARTNER FUND III	2,227,990	2,227,990	1,322,087	0.51%
<b>INSTITUTIONAL VENTURE CAPITAL FUND III</b>	<b>6,047,799</b>	<b>6,047,799</b>	<b>3,431,750</b>	<b>1.33%</b>
BRINSON VENTURE CAPITAL FUND IV	14,108,333	14,108,333	9,500,241	3.68%
<b>BRINSON VENTURE CAPITAL FUND IV</b>	<b>14,108,333</b>	<b>14,108,333</b>	<b>9,500,241</b>	<b>3.68%</b>
BRINSON NON US PARTNERSHIP FUND	4,475,554	4,475,554	5,055,644	1.96%
BRINSON PARTNERSHIP FUND TRUST	48,680,492	48,680,492	43,212,407	16.72%
<b>BRINSON PARTNERSHIP TRUST</b>	<b>53,156,046</b>	<b>53,156,046</b>	<b>48,268,051</b>	<b>18.67%</b>
ADAMS NON US PARTNERSHIP FUND	1,645,000	1,645,000	1,733,290	0.67%
ADAMS STREET PARTNERSHIP FUND	7,552,000	7,552,000	7,577,518	2.93%
<b>ADAMS STREET PARTNERS TRUST</b>	<b>9,197,000</b>	<b>9,197,000</b>	<b>9,310,809</b>	<b>3.60%</b>
ADAMS STREET FUND V	8,000,000	8,000,000	7,421,640	2.87%
<b>ADAMS STREET FUND V</b>	<b>8,000,000</b>	<b>8,000,000</b>	<b>7,421,640</b>	<b>2.87%</b>
ADAMS STREET GLOBAL OPPORTUNITES	1,312,500	1,312,500	1,389,141	0.54%
<b>ADAMS STREET GLOBAL OPPORTUNITES</b>	<b>1,312,500</b>	<b>1,312,500</b>	<b>1,389,141</b>	<b>0.54%</b>
<b>ADAMS STREET TOTAL</b>	<b>94,465,458</b>	<b>94,465,458</b>	<b>80,488,832</b>	<b>31.14%</b>
ARCLIGHT ENERGY PARTNERS FUND II	2,076,300	2,076,300	2,076,300	0.80%
<b>ARCLIGHT CAPITAL TOTAL</b>	<b>2,076,300</b>	<b>2,076,300</b>	<b>2,076,300</b>	<b>0.80%</b>
KKR 1986 1987	13,562,439	13,562,439	4,941,054	1.91%
KKR 1993	4,006,575	4,006,575	3,835,923	1.48%
KKR 1996	50,311,901	50,311,901	55,540,666	21.49%
KKR EUROPEAN FUND	16,893,417	16,893,417	15,776,593	6.10%
<b>KKR TOTAL</b>	<b>84,774,332</b>	<b>84,774,332</b>	<b>80,094,236</b>	<b>30.99%</b>
LEXINGTON CAPITAL PARTNERSHIP V LP	12,855,368	12,855,368	17,820,972	6.89%
<b>LEXINGTON CAPITAL TOTAL</b>	<b>12,855,368</b>	<b>12,855,368</b>	<b>17,820,972</b>	<b>6.89%</b>
MADISON DEARBORN CAPITAL PARTNERSHIP IV	6,005,793	6,005,793	5,595,706	2.16%
MDP IV GLOBAL INVESTMENTS LP	2,478,137	2,478,137	2,956,219	1.14%
<b>MADISON DEARBORN TOTAL</b>	<b>8,483,930</b>	<b>8,483,930</b>	<b>8,551,924</b>	<b>3.31%</b>

<u>Security Name</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
OAKTREE CAPITAL OPPORTUNITIES FUND IVB LP	1	1	32,498,809	12.57%
<b>OAKTREE CAPITAL TOTAL</b>	<b>1</b>	<b>1</b>	<b>32,498,809</b>	<b>12.57%</b>
WELSH CARSON ANDERSON STOWE IX	10,107,970	10,107,970	12,717,565	4.92%
<b>WELSH CARSON ANDERSON STOWE TOTAL</b>	<b>10,107,970</b>	<b>10,107,970</b>	<b>12,717,565</b>	<b>4.92%</b>
<b>TOTAL PRIVATE EQUITIES</b>	<b>212,763,359</b>	<b>212,763,359</b>	<b>234,248,639</b>	<b>90.63%</b>
STATE STREET SPIFF	164,951	23,947,684	24,229,851	9.37%
<b>TOTAL EQUITY FUTURES</b>	<b>164,951</b>	<b>23,947,684</b>	<b>24,229,851</b>	<b>9.37%</b>
<b>MPEP TOTAL</b>	<b>212,928,310</b>	<b>236,711,043</b>	<b>258,478,490</b>	<b>100.00%</b>



## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Investments Managed for the state of Montana Board of Investments, All Other Funds, as of June 30, 2004, and 2003, and the related Statement of Net Investment Income and Statement of Changes in Net Investments Managed for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net investments managed by the Montana Board of Investments, All Other Funds, as of June 30, 2004, and 2003, and its net investment income and changes in its net investments managed for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**STATE OF MONTANA BOARD OF INVESTMENTS  
ALL OTHER FUNDS FINANCIAL STATEMENTS**

**STATEMENT OF NET INVESTMENTS MANAGED, JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<b><u>Assets</u></b>		
Investments managed at fair value (amortized cost of \$1,324,087,590 in 2004 and \$1,360,107,546 in 2003) (Notes 2 and 10)	\$ 1,341,236,868	\$ 1,403,338,502
Security lending cash collateral (Notes 3 and 6)	226,699,848	56,643,400
Interest receivable	13,924,158	12,921,901
Broker receivable for securities sold but not settled (Note 2)	<u>384,976</u>	<u>1,276,972</u>
<b>Total assets</b>	<b>\$ <u>1,582,245,850</u></b>	<b>\$ <u>1,474,180,775</u></b>
<b><u>Liabilities</u></b>		
Unrealized gain (loss)	\$ 17,149,278	\$ 43,230,956
Security lending obligations	226,699,848	56,643,400
Security lending expense payable	186,928	66,939
Broker payable for securities purchased but not settled (Note 2)	0	1,592,849
Accounts payable	<u>10,287</u>	<u>9,430</u>
<b>Total liabilities</b>	<b>\$ <u>244,046,341</u></b>	<b>\$ <u>101,543,574</u></b>
<b>Net investments managed</b>	<b>\$ <u>1,338,199,509</u></b>	<b>\$ <u>1,372,637,201</u></b>

**STATEMENT OF NET INVESTMENT INCOME  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

<b><u>Income</u></b>		
Investment income (Note 2)	\$ 65,361,798	\$ 77,235,644
Realized gain on sales (Note 2)	76,319,791	33,141,817
Amortization/accretion	(458,413)	330,020
Security lending income	<u>1,593,123</u>	<u>1,568,875</u>
<b>Total income</b>	<b>\$ <u>142,816,299</u></b>	<b>\$ <u>112,276,356</u></b>
<b><u>Expenses</u></b>		
Administrative expenses	1,303,746	1,287,070
Security lending expense	<u>1,410,223</u>	<u>1,379,262</u>
<b>Total expenses</b>	<b>\$ <u>2,713,969</u></b>	<b>\$ <u>2,666,332</u></b>
<b>Net investment income</b>	<b>\$ <u>140,102,330</u></b>	<b>\$ <u>109,610,024</u></b>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS  
ALL OTHER FUNDS FINANCIAL STATEMENTS**

**STATEMENT OF CHANGES IN NET INVESTMENTS MANAGED  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
Total net investments managed, beginning of year	\$ 1,372,637,201	\$ 1,810,978,391
Net investment income	140,102,330	109,610,024
Income remitted to agencies	<u>141,104,587</u>	<u>(108,145,767)</u>
Increase (decrease) in interest receivable	1,002,257	(1,464,257)
Increase (decrease) in broker receivable (Note 2)	(891,995)	1,089,011
Increase (decrease) in security lending cash collateral (Notes 3 and 6)	170,056,448	(53,316,831)
Investments purchased	1,172,224,997	1,322,395,416
Transfer of BGI and DFA investments to MDEP (Note 2)	0	(740,000,000)
Investments sold, matured and called (Note 10)	<u>(1,207,786,541)</u>	<u>(1,044,202,693)</u>
Increase (decrease) in book value of investments	(35,561,544)	(461,807,277)
Increase (decrease) in book value of investments due to net amortization of discounts and premiums	(458,413)	330,020
(Increase) decrease in broker payable (Note 2)	1,592,849	23,407,151
(Increase) decrease in accounts payable	(857)	1,668
(Increase) decrease in security lending obligations (Notes 3 and 6)	(170,056,448)	53,316,831
(Increase) decrease in security lending expense payable	<u>(119,989)</u>	<u>102,494</u>
Net investments managed, end of year	\$ <u><u>1,338,199,509</u></u>	\$ <u><u>1,372,637,201</u></u>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS  
ALL OTHER FUNDS  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2004 AND 2003**

**1. HISTORY AND ORGANIZATION**

The Board was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis per section 17-6-201, MCA. The All Other Funds (AOF) investments and income are owned by various State of Montana agencies and managed on their behalf by the Board.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Investments**

The AOF investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle" and applicable investment restrictions of the participants. The AOF portfolio includes securities classified as corporate asset-backed, other corporate, US government mortgage-backed, US government, Yankee bonds, equity index, real estate, mortgages and loans. Corporate asset-backed securities represent debt securities collateralized by a pool of assets. US government mortgage-backed securities reflect participation in a pool of residential mortgages. US government securities include direct obligations of the US Treasury and indirect obligations of the US government. Yankee bonds are US dollar denominated bonds issued by foreign corporations and governments and US companies issuing debt in foreign markets. Equity index investments are investments in selected mutual funds whose equity portfolios match a broad based index or composite.

The AOF portfolio includes structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. Strip investments represent the separate purchase of the principal and interest cash flows of a mortgage security. These securities, purchased for portfolio diversification and a competitive rate of return, are identified and reported as government mortgage-backed securities in the investment risk and portfolio disclosures. (See Note 6 on Investment Risk Categories and Note 10 for the Year End Portfolio.)

AOF fixed income securities pay a fixed rate of interest until maturity while the variable-rate (floating-rate) securities pay a variable interest rate until maturity. The AOF variable-rate securities float with LIBOR (London Interbank Offered Rate) or the weighted average of the net mortgage interest rates for the mortgage loan group. The one variable-rate security, with an amortized cost of \$15,585,949 and \$17,889,456 as of June 30, 2004 and 2003, respectively, is identified and reported as a government mortgage-backed security in the investment risk and portfolio disclosures. (See Note 6 on Investment Risk Categories and Note 10 for the Year End Portfolio.)

Effective May 1, 2003, all the Barclays Global Investors (BGI) S&P 500 Equity Index Fund A and the Dimensional Fund Advisors (DFA) US Small Cap Trust investments totaling \$740 million, at cost, were transferred from the All Other Funds portfolio to the new Montana Domestic Equity Pool (MDEP). These investments were held by the Public Employees', Municipal Police Officers', Game Wardens', Sheriffs', Judges', Highway Patrol Officers', Teachers', Volunteer Firefighters' and Firefighters' Unified retirement funds.

Investments are presented in the Statement of Net Investments Managed at fair value. Fair values for publicly traded securities are determined primarily by reference to market prices supplied to the Board by the Board's custodial bank, State Street Bank and Trust. The real estate investments and residential and multi-family mortgages are valued based on a discounted cash flow. The commercial in-state coal tax loans and the nonparticipating repurchase agreements are reported at amortized cost. Amortized cost, parenthetically disclosed, represents the original cost, adjusted for premium and discount amortization where applicable. Premiums and discounts are amortized/accreted using the straight-line or scientific method to the call, average life or maturity date of the securities. Amortized cost may also be referred to as book value.

**Broker Receivable/Payable**

All Other Funds security transactions are recorded as of the trade date rather than the settlement date. Because of this generally accepted practice, the AOF portfolio at June 30 may include receivables from brokers for securities sold but not delivered, and payables to brokers for securities purchased but not received.

### **Montana Mortgages and Loans Receivable**

The Montana mortgages and loans receivable, included in the Net Investments Managed at Fair Value, represent residential mortgages and multifamily commercial loans funded by the Public Employees' and Teachers' pension funds and other loans funded by the Coal Severance Tax Trust fund. The Coal Severance Tax Trust loan portfolio includes loans made by the Montana Science and Technology Alliance (MSTA) Board. The MSTTA Board was abolished on July 1, 1999 and by law, the MSTTA portfolio was assigned to the Board of Investments (BOI). (See Note 7 for the Montana mortgages and loans portfolio.)

As of June 30, 2004 and 2003, there were no uncollectible account balances for Montana mortgages and loans receivable.

### **Investment Income**

Investment income reported in the Statement of Net Investment Income includes fixed income and mortgage interest earnings, real estate income, commercial loan interest earnings and commitment fees. For fiscal year 2004, the decrease in interest income of \$11.9 million is attributed, primarily, to a decrease in the commercial loan and mortgage interest earnings.

### **Realized Gain on Sales**

Realized gain on sales reported in the Statement of Net Investment Income represents the net gain/loss resulting from the sale of fixed income, private equity and pool investments. The sale of pool units in fiscal year 2004 from the Montana Domestic Equity Pool (MDEP), Montana Private Equity Pool (MPEP), Retirement Funds Bond Pool (RFBP) and Trust Funds Bond Pool (TFBP) resulted in a net gain to participants of \$73,214,644. In fiscal year 2003, the sale of pool units from the Montana Private Equity Pool (MPEP), Trust Funds Bond Pool (TFBP), Retirement Funds Bond Pool (RFBP) and the Montana Stock Pool (MTCP) generated a net gain to participants of \$41,475,231.

## **3. SECURITIES LENDING**

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street Bank loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit as collateral. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street Bank made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street Bank.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine.

As of June 30, 2004, the carrying and fair value of the underlying securities on loan for the All Other Funds was \$219,045,397 and \$222,235,651, respectively. The collateral provided for the securities on loan totaled \$228,078,235 representing \$226,699,848 in cash and \$ 1,378,387 in securities collateral.

As of June 30, 2003, the carrying and fair value of the underlying securities on loan for the All Other Funds was \$49,363,730 and \$55,128,809, respectively. The collateral provided for the securities on loan totaled \$56,643,400 in cash collateral.

#### 4. COAL TAX LOAN AND MORTGAGE COMMITMENTS

The Board makes firm commitments to fund loans from the Coal Severance Tax Trust fund. These commitments have expiration dates and may be extended according to the Board's policies. As of June 30, 2004, the Board had committed but not yet purchased \$69,281,764 in loans from Montana lenders, compared to \$57,672,181 as of June 30, 2003. In addition to the above commitments, lenders had reserved \$12,021,150 for loans as of June 30, 2004, compared to \$41,421,046 on the same date in 2003.

The Board makes firm commitments to fund mortgages from the Public Employees' and Teachers' retirement funds. As of June 30, 2004 and 2003, the Board had committed but not yet purchased from Montana lenders mortgages totaling \$124,550 and \$392,275, respectively. Lenders had reserved no funding for mortgages as of June 30, 2004 and as of June 30, 2003.

#### 5. PENSION FUND REAL ESTATE INVESTMENTS

##### 100 North Park Building

In January 1996, the Board, on behalf of the Public Employees' and Teachers' Retirement funds, purchased the 100 North Park Avenue Building in Helena, Montana as a real estate investment. Acquired for a cost of \$4,864,326, the building carries a fair value of \$5,795,000 as of June 30, 2004. During fiscal year 2004, building improvements for lighting, fire alarms, sprinkler systems, hallway remodeling and leasing fees totaling \$453,209 were added to the cost of the building. Building improvements and leasing fees totaling \$129,465 were added to the cost of the building in fiscal year 2003. The three-story building provides office space for approximately eight to ten tenants.

##### 2401 Colonial Drive Building

In August 1997, the Board authorized the construction of an office building, as a real estate investment owned equally by the Public Employees' and Teachers' Retirement funds. Construction costs, including interest capitalization, totaled \$6,481,741 as of June 30, 2000. In fiscal year 2004, office remodeling payments and leasing fees of \$54,517 were added to the building cost. For fiscal year 2003, \$155,800 was expended on building landscaping, leasing fees, lighting and construction. The three-story building, providing office space for three tenants, was occupied in November 1999. As of June 30, 2004, the building carries a cost and fair value of \$7,041,755 and \$7,581,000, respectively.

##### 2273 Boot Hill Court Building

In August 1999, the Board authorized the purchase of a new office building in Bozeman, Montana. Upon construction completion, the Public Employees' and Teachers' Retirement funds purchased the building, in March 2004, as a real estate investment with equal ownership, for \$2,051,032. The building, located on state school trust land, is occupied by four state agencies. As of June 30, 2004, the building carries a fair value of \$2,082,014.

##### 1712 Ninth Avenue Building

In November 2000, the Board reviewed the transfer of the Public Employees' Retirement Administration (PERA) office building, located at 1712 Ninth Avenue, Helena, to the Board of Investments. By issuance of a corrective deed, the Board of Investments was named owner and building manager for the use and benefit of the PERA. During fiscal years 2004 and 2003, parking lot improvements, architect fees, and remodeling construction totaling \$9,525 and \$160,480, respectively, were added to the building cost for a year end book value of \$498,712. As of June 30, 2004, the building is valued at \$576,369.

The schedule below details the minimum future rentals for the above buildings with non-cancelable operating leases as of June 30, 2004 and 2003:

##### Minimum future rentals for the year ending June 30, 2004:

<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010+</u>	<u>Total</u>
\$773,141	\$497,523	\$442,228	\$308,401	\$243,861	\$980,388	\$3,245,543

##### Minimum future rentals for the year ending June 30, 2003:

<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009+</u>	<u>Total</u>
\$241,763	\$181,792	\$164,149	\$155,328	\$129,439	\$0	\$872,471

## California Street Property

In December 1998, the Board acquired a parcel of land adjacent to the Colonial Drive building to provide for additional parking. This land was purchased for \$204,835. As of June 30, 2004 the property carries a fair value of \$207,667.

### 6. INVESTMENT RISK CATEGORIES

State of Montana investments are categorized below and on the next page to give an indication of the level of risk assumed at June 30, 2004 and June 30, 2003. Category 1 includes investments that are insured or registered, or securities that are held by the Board or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral. Long-term investments are carried at amortized cost and short-term investments are carried at original cost.

Risk as of June 30, 2004

Long-Term Investments

C a t e g o r y 1

<u>Security Investment Type</u>	<u>Securities Not On Loan</u>	<u>On Loan for Securities Collateral*</u>	<u>Not Categorized*</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Corporate Asset-Backed	\$ 40,247,993	\$ 0	\$ 0	\$ 40,247,993	\$ 39,703,357
Corporate Other	256,849,605	0	31,745,041	288,594,646	296,528,381
US Govt Direct/Indirect	272,487,502	1,365,535	185,934,821	459,787,858	464,052,287
US Govt Mortgage-Backed	57,688,739	0	0	57,688,739	58,528,244
Yankee Bonds	9,940,133	0	0	9,940,133	10,714,069
Total	\$ <u>637,213,972</u>	\$ <u>1,365,535</u>	\$ <u>217,679,862</u>	\$ <u>856,259,369</u>	\$ <u>869,526,338</u>

#### Direct Investments

Equity Index Fund	68,406,676	72,138,374
Equity Other	15	23
Real Estate	16,092,940	16,242,050
MT Mortgages and Loans	<u>345,481,014</u>	<u>345,482,507</u>
Total Long-Term	<u>1,286,240,014</u>	<u>1,303,389,292</u>

Short-Term Investments

Municipal Investor Account	37,847,576	37,847,576
US Bank Sweep	<u>0</u>	<u>0</u>
Total Short-Term	<u>37,847,576</u>	<u>37,847,576</u>

TOTAL INVESTMENTS \$ 1,324,087,590 \$ 1,341,236,868

Securities Lending Collateral Investment Pool	\$ <u>226,699,848</u>	\$ <u>226,699,848</u>	\$ <u>226,699,848</u>
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\*At June 30, 2004, these underlying securities, with fair values of \$1,328,020 and \$220,907,631, respectively, were loaned for securities and cash collateral under a security lending agreement with the state's agent.

Risk as of June 30, 2003

Long-Term Investments  
Category 1

<u>Security Investment Type</u>	<u>Securities Not On Loan</u>	<u>On Loan for Securities Collateral*</u>	<u>Not Categorized*</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Corporate Asset-Backed	\$ 27,192,828	\$ 0	\$ 0	27,192,828	\$ 28,069,081
Corporate Other	238,439,395	0	3,986,781	242,426,176	262,880,396
US Govt Direct/Indirect	262,143,080	0	44,897,100	307,040,180	330,784,346
US Govt Mortgage-Backed	89,289,805	0	0	89,289,805	92,741,823
Yankee Bonds	<u>18,479,589</u>	<u>0</u>	<u>479,849</u>	<u>18,959,438</u>	<u>20,603,889</u>
Total	\$ <u>635,544,697</u>	\$ <u>0</u>	\$ <u>49,363,730</u>	\$ <u>684,908,427</u>	\$ <u>735,079,535</u>

Direct Investments

Equity Index Fund	79,000,000	69,958,153
Equity Other	15	17
Real Estate	13,512,086	13,927,253
MT Mortgages and Loans	<u>442,681,780</u>	<u>444,368,306</u>
Total Long-Term	<u>1,220,102,308</u>	<u>1,263,333,264</u>

Short-Term Investments

Municipal Investor Account	138,412,389	138,412,389
US Bank Sweep	<u>1,592,849</u>	<u>1,592,849</u>
Total Short-Term	<u>140,005,238</u>	<u>140,005,238</u>

TOTAL INVESTMENTS \$ 1,360,107,546 \$ 1,403,338,502

Securities Lending Collateral Investment Pool	\$ <u>56,643,400</u>	\$ <u>56,643,400</u>	\$ <u>56,643,400</u>
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\*At June 30, 2003, these underlying securities, with a fair value of \$55,128,809 were loaned for cash collateral under a security lending agreement with the state's agent.

With the exception of the US government securities, the fixed income instruments have credit risk as measured by major credit rating services. Credit risk is defined as the risk that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires AOF fixed income investments, at the time of purchase, to be rated an investment grade as defined by Moody's and Standard & Poor's (S&P) rating services. The US government securities are guaranteed directly or indirectly by the US government.

Market risk for the above securities is caused by changes in the price or principal value of the security due to changes in interest rates and market liquidity.

As reported in the U.S. government mortgage-backed category, the AOF portfolio holds a REMIC with an amortized cost of \$15,585,949 and \$17,889,456 as of June 30, 2004 and 2003. The REMIC securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages. When underlying mortgages are prepaid, the interest cash flows are reduced while principal cash flows are increased. If homeowners pay on mortgages longer than anticipated, the cash flow effect would be the opposite.

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, and other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets. Market risk is also less because principal is paid back prior to the maturity date of the securities.

## 7. MONTANA MORTGAGES AND LOANS

The Montana mortgages and loans portfolio is shown below.



<u>Montana Mortgages and Loans</u>	<u>2004 Book Value</u>	<u>2003 Book Value</u>
<b>Multifamily Commercial Loans</b>	<b>\$ 4,105,800</b>	<b>\$ 10,173,421</b>
<b>Residential Mortgages</b>	<b>119,513,572</b>	<b>195,687,788</b>
Science and Technology Alliance <sup>(1)</sup>	13,959,035	14,287,541
Department of Natural Resources <sup>(2)</sup>	44,546,088	46,366,904
Department of Justice	2,037,000	1,902,000
Montana Facility Finance	943,904	1,543,021
Local Government Infrastructure	8,298,805	9,050,975
Value-added Loans	9,202,821	6,854,640
Department of Revenue <sup>(3)</sup>	5,698,442	0
Commercial Loans	<u>137,175,547</u>	<u>156,815,490</u>
<b>Permanent Coal Trust Loans</b>	<b>221,861,642</b>	<b>236,820,571</b>
<b>Total Montana Mortgages and Loans</b>	<b>\$ <u>345,481,014</u></b>	<b>\$ <u>442,681,780</u></b>

(1) The Montana Science and Technology Alliance (MSTA) loans include funding for research and development, mezzanine and seed capital loans.

(2) In accordance with Senate Bill 495 enacted by the 2001 Legislature, the Coal Severance Tax Permanent Trust loaned 483,604 TFBP shares, with a book value of \$46,366,904, to the Department of Natural Resources, Trust and Legacy fund on July 2, 2001. The loan proceeds were deposited in the Trust and Legacy Fund. A loan receivable was recorded in the Coal Severance Tax Permanent Trust and a corresponding liability was recorded in the Guarantee Fund, a General Fund sub-fund. The August 2002 Special Legislative Session approved the request to record this activity in a state special revenue fund of the Office of Public Instruction rather than in the Guarantee Fund. On June 30, 2004, the Trust and Legacy Fund paid \$1,820,816 to the Coal Severance Tax Permanent Trust reducing the TFBP shares on loan to 464,613 with a corresponding book value of \$44,546,088.

(3) On August 26, 2004, the Board voted to increase the Department of Revenue loan commitment to \$17 million. This loan provides funding for the Department of Revenue's POINTS Computer System replacement project, IRIS.

## 8. DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The Board received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, \$2 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of \$94.669 plus accrued interest. Deutsche Bank Securities seeks damages of \$215,453 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The Board tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of \$113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the Board received \$2,273,230 in principal and interest plus \$60,000 as a consent fee. As of November 15, 2004, this matter is still pending.

## 9. LOAN GUARANTEES

As of June 30, 2004, loan guarantees provided by the Coal Severance Tax Permanent Trust to the Enterprise Fund and the Montana Facility Finance Authority, totaled \$126,787,072. Board of Investment exposure to bond issues of the Enterprise Fund was \$92,052,796 while exposure to bond issues and surety bonds of the Facility Finance Authority was \$34,734,276.

As of June 30, 2003, loan guarantees provided by the Coal Severance Tax Permanent Trust to the Enterprise Fund and the Montana Facility Finance Authority total \$110,596,691. Board of Investment exposure to bond issues of the Enterprise Fund is \$74,478,374 while exposure to bond issues and surety bonds of the Facility Finance Authority is \$36,118,317.

# 10. YEAR END PORTFOLIO

The June 30, 2004 All Other Funds portfolio is listed below. The security type percentage is based on the fair value ratio of the specific category of securities to the total portfolio.

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
AA / FT WORTH HQ FINANCIAL TRUST	5.500	10/05/10	12,134,884	12,134,884	12,098,237	0.90%
J P MORGAN CHASE COMMERCIAL MORTGAGE TR	4.200	07/12/35	23,078,351	23,188,171	22,822,359	1.70%
J P MORGAN CHASE COMMERCIAL MORTGAGE TR	3.053	01/15/38	4,903,231	4,924,938	4,782,761	0.36%
<b>CORPORATE ASSET-BACKED</b>			<b>40,116,466</b>	<b>40,247,993</b>	<b>39,703,357</b>	<b>2.96%</b>
ABBOTT LABS	3.500	02/17/09	10,000,000	9,951,145	9,742,007	0.73%
AMERICAN AIRLINE EQUIPMENT TRUST	6.977	05/23/21	3,832,898	3,822,785	3,401,697	0.25%
AMERICAN TRANS AIR EQUIPMENT TRUST	8.039	07/15/17	4,312,092	4,312,092	4,373,947	0.33%
ASHLAND INC	7.830	08/15/05	10,000,000	10,000,000	10,507,598	0.78%
BANK OF AMERICA	7.875	05/16/05	5,000,000	5,078,668	5,239,577	0.39%
BANK AMERICA CORP	3.375	02/17/09	5,000,000	4,975,940	4,811,657	0.36%
BANK AMERICA CORP	5.375	06/15/14	5,000,000	4,954,438	4,959,675	0.37%
BANK ONE	6.250	02/15/08	2,000,000	1,940,772	2,154,044	0.16%
BANKBOSTON NA	6.375	03/25/08	2,000,000	1,943,988	2,161,875	0.16%
BORG WARNER AUTOMOTIVE INC	7.000	11/01/06	4,000,000	4,034,911	4,307,633	0.32%
BURLINGTON NORTHERN RR CO	6.940	01/02/14	3,414,052	3,414,052	3,761,450	0.28%
BURLINGTON NORTHERN SANTA FE RY	7.160	01/02/20	4,530,651	4,530,651	5,004,991	0.37%
CIT GROUP EQUIPMENT TRUST	6.490	01/05/21	7,758,301	7,758,301	8,154,767	0.61%
CIT GROUP INC	5.750	09/25/07	5,000,000	5,138,182	5,270,901	0.39%
CSX CORP	7.450	05/01/07	5,000,000	4,997,859	5,479,353	0.41%
CENTEX CORP	5.700	05/15/14	3,000,000	2,995,924	2,940,331	0.22%
CITIGROUP INC	5.750	05/10/06	1,000,000	999,967	1,047,166	0.08%
CITIGROUP INC	6.000	02/21/12	5,000,000	4,998,586	5,317,109	0.40%
CITIGROUP INC	3.625	02/09/09	5,000,000	4,988,939	4,863,684	0.36%
CONSOLIDATED NATURAL GAS CO	7.250	10/01/04	10,000,000	9,998,872	10,135,728	0.76%
CONTINENTAL AIRLINES EQUIPMENT TRUST	6.563	08/15/13	5,000,000	5,021,539	5,200,027	0.39%
COUNTRYWIDE HOME LOANS INC	2.875	02/15/07	8,000,000	7,990,236	7,826,680	0.58%
DELTA AIR LINES INC	6.417	07/02/12	10,000,000	9,964,203	10,343,739	0.77%
DETROIT EDISON CO	5.200	10/15/12	5,000,000	4,942,565	4,997,813	0.37%
DONNELLEY R R + SONS CO	4.950	04/01/14	5,000,000	4,800,701	4,768,987	0.36%
FIRST BANK NA	8.350	11/01/04	5,000,000	4,999,832	5,102,634	0.38%
FIRST CHICAGO CORP	6.375	01/30/09	2,000,000	1,911,654	2,160,882	0.16%
FIRST UNION CORP	7.050	08/01/05	5,000,000	4,993,465	5,245,041	0.39%
FIRST UNION CORP	7.100	08/15/04	1,000,000	999,937	1,006,735	0.08%
FORD MOTOR CREDIT CO	6.700	07/16/04	10,000,000	10,001,085	10,019,171	0.75%
GENERAL ELECTRIC CAPITAL CORP	5.375	03/15/07	10,000,000	10,172,561	10,484,486	0.78%
GENERAL MOTORS ACCEPTANCE CORP	7.500	07/15/05	9,000,000	8,998,226	9,417,677	0.70%
GENERAL MOTORS ACCEPTANCE CORP	6.125	08/28/07	5,000,000	5,005,784	5,216,097	0.39%
GOLDMAN SACHS GROUP INC	3.875	01/15/09	5,000,000	5,051,456	4,887,348	0.36%
J P MORGAN CHASE + CO	5.350	03/01/07	5,000,000	4,986,642	5,227,520	0.39%
J P MORGAN CHASE + CO	3.500	03/15/09	10,000,000	9,944,109	9,603,677	0.72%
KCT INTERMODAL EQUIPMENT TRUST	6.884	08/01/18	3,617,867	3,617,867	3,898,528	0.29%
K N ENERGY INC	6.650	03/01/05	7,000,000	7,017,659	7,190,981	0.54%
KEYCORP	7.500	06/15/06	5,000,000	4,998,087	5,400,278	0.40%
MARSH AND MCLENNAN COS INC	7.125	06/15/09	3,000,000	2,996,314	3,360,438	0.25%
MERRILL LYNCH AND CO INC	4.125	01/15/09	5,000,000	4,997,337	4,960,459	0.37%
METLIFE INC	5.000	11/24/13	5,000,000	4,954,844	4,848,260	0.36%
NATIONWIDE FINANCIAL SERVICES INC	6.250	11/15/11	5,000,000	5,302,878	5,181,947	0.39%
NORFOLK SOUTHERN CORP	7.350	05/15/07	3,500,000	3,499,306	3,833,843	0.29%
NORTHWEST AIRLINES EQUIPMENT TRUST	6.810	02/01/20	4,284,297	4,225,694	4,134,346	0.31%
OLD REPUBLIC INTERNATIONAL CORP	7.000	06/15/07	3,000,000	2,999,520	3,278,814	0.24%
PPL MONTANA LLC	8.903	07/02/20	4,367,175	4,367,175	5,125,953	0.38%
PRINCIPAL LIFE GLOBAL FDG	5.125	10/15/13	5,000,000	4,993,173	4,905,588	0.37%
SOUTHWEST GAS CORP	8.375	02/15/11	4,000,000	3,995,953	4,431,728	0.33%
UNION PACIFIC CORP	6.400	02/01/06	5,000,000	4,993,824	5,265,305	0.39%
UNION PACIFIC RESOURCES GROUP INC	7.000	10/15/06	5,000,000	4,993,270	5,375,164	0.40%
UNION TANK CAR CO	7.125	02/01/07	2,000,000	1,999,447	2,175,447	0.16%
WACHOVIA CORP	4.950	11/01/06	3,000,000	2,996,929	3,110,970	0.23%
WAL MART STORES INC PASS THRU TRUST	8.450	07/01/04	274,484	274,484	274,535	0.02%
WELLS FARGO + CO	5.900	05/21/06	1,000,000	999,535	1,052,144	0.08%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
WELLS FARGO + CO	4.625	04/15/14	5,000,000	4,789,281	4,710,174	0.35%
WESTERN PROPERTIES REIT	7.200	09/15/08	1,000,000	975,124	1,096,345	0.08%
WYETH	5.500	02/01/14	5,000,000	4,990,724	4,807,679	0.36%
ZIONS BANCORPORATION	5.650	05/15/14	3,000,000	2,996,155	2,965,755	0.22%
<b>CORPORATE OTHER</b>			<b>288,891,816</b>	<b>288,594,646</b>	<b>296,528,381</b>	<b>22.11%</b>
ENSCO OFFSHORE CO USGG XI	6.360	12/01/15	11,500,184	11,500,184	12,418,359	0.93%
FEDERAL HOME LOAN MORTGAGE CORP	4.750	10/11/12	20,000,000	20,037,951	19,423,310	1.45%
FEDERAL HOME LOAN MORTGAGE CORP	5.125	05/13/13	20,000,000	20,000,000	19,840,656	1.48%
FEDERAL HOME LOAN MORTGAGE CORP	4.000	07/18/18	5,000,000	5,000,000	4,609,041	0.34%
FREDDIE MAC	4.100	01/28/14	15,000,000	15,000,000	14,396,730	1.07%
FEDERAL HOME LOAN MORTGAGE CORP	2.850	02/23/07	20,000,000	19,974,766	19,764,254	1.47%
FEDERAL AGRICULTURE MORTGAGE CORP	5.300	04/24/06	20,000,000	20,975,239	20,840,620	1.55%
FEDERAL HOME LOAN BANKS	4.875	11/15/06	5,000,000	4,966,278	5,187,639	0.39%
FEDERAL HOME LOAN BANKS	4.875	02/15/07	5,000,000	4,999,422	5,185,206	0.39%
FEDERAL HOME LOAN BANKS	3.500	08/15/06	10,000,000	10,240,813	10,072,788	0.75%
FEDERAL HOME LOAN BANKS	2.500	12/15/05	10,000,000	10,028,046	9,981,572	0.74%
FEDERAL HOME LOAN BANKS	2.500	03/15/06	10,000,000	10,038,663	9,941,230	0.74%
FEDERAL HOME LOAN BANKS	2.375	02/15/06	15,000,000	15,004,226	14,899,853	1.11%
FEDERAL HOME LOAN BANKS	2.250	05/15/06	10,000,000	9,979,216	9,878,765	0.74%
FEDERAL HOME LOAN BANKS	3.625	11/14/08	10,000,000	9,979,795	9,821,302	0.73%
FEDERAL HOME LOAN BANKS	2.750	11/15/06	10,000,000	10,060,220	9,894,365	0.74%
FEDERAL HOME LOAN MORTGAGE CORP	5.625	03/15/11	10,000,000	10,062,385	10,534,100	0.79%
FEDERAL HOME LOAN MORTGAGE CORP	6.000	06/15/11	15,000,000	14,990,754	16,119,744	1.20%
FEDERAL HOME LOAN MORTGAGE CORP	2.875	09/15/05	10,000,000	10,091,192	10,053,498	0.75%
FEDERAL HOME LOAN MORTGAGE CORP	1.500	08/15/05	10,000,000	9,932,996	9,906,536	0.74%
FEDERAL HOME LOAN MORTGAGE CORP	2.125	11/15/05	22,000,000	21,989,821	21,871,901	1.63%
FEDERAL HOME LOAN MORTGAGE CORP	3.375	04/15/09	2,000,000	1,965,654	1,928,726	0.14%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	5.750	02/15/08	5,000,000	5,479,673	5,329,132	0.40%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	6.000	05/15/08	5,000,000	4,915,765	5,383,304	0.40%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	0.000	06/01/17	14,600,000	6,373,004	7,000,960	0.52%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	7.250	01/15/10	8,000,000	8,319,494	9,107,509	0.68%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	7.000	07/15/05	22,000,000	22,953,514	23,062,596	1.72%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	6.625	10/15/07	15,000,000	15,913,761	16,386,693	1.22%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	6.625	11/15/10	10,000,000	10,277,099	11,104,473	0.83%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	6.000	12/15/05	2,000,000	2,010,386	2,096,194	0.16%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	5.250	06/15/06	5,000,000	5,020,710	5,215,611	0.39%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	4.375	07/17/13	20,000,000	19,289,755	18,746,594	1.40%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	4.125	04/15/14	10,000,000	9,367,083	9,206,043	0.69%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	3.010	06/02/06	15,000,000	14,993,248	14,971,751	1.12%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	5.875	02/14/06	5,000,000	4,953,813	5,247,225	0.39%
FEDERAL NATIONAL MORTGAGE ASSOCIATION	3.250	05/11/07	15,000,000	14,986,592	14,875,874	1.11%
GLOBAL INDUSTRIES LTD USGG XI	7.710	02/15/25	4,200,000	4,200,000	4,200,000	0.31%
MAYBANK NAVIGATION CO LLC USGG XI	7.620	07/25/20	4,125,000	4,125,000	3,980,625	0.30%
NORTH AMERICAN SHIP BUILDING USGG XI	5.840	02/15/06	1,282,000	1,282,000	1,282,000	0.10%
PERFORADORA CENT S A DE C V USGG XI	5.630	07/15/11	14,689,000	14,679,341	15,387,315	1.15%
ROWAN COS INC USGG XI	5.880	03/15/12	18,179,000	18,179,000	19,247,198	1.44%
TRICO MARINE INTERNATIONAL USGG XI	6.080	09/01/06	3,125,000	3,125,000	3,125,000	0.23%
MAY BANK NAVIGATION CO LLC USGG XI	5.900	09/16/13	2,526,000	2,526,000	2,526,000	0.19%
<b>GOVERNMENT DIRECT-INDIRECT</b>			<b>465,226,184</b>	<b>459,787,858</b>	<b>464,052,287</b>	<b>34.60%</b>
FEDERAL HOME LOAN POOL G10814	5.500	05/01/13	3,685,977	3,683,526	3,791,516	0.28%
FEDERAL HOME LOAN POOL G10173	6.000	01/01/09	407,263	406,228	425,638	0.03%
FEDERAL HOME LOAN POOL E00247	5.500	10/01/08	328,741	325,339	337,821	0.03%
FEDERAL HOME LOAN POOL E00540	6.000	03/01/13	2,356,614	2,350,018	2,465,883	0.18%
FEDERAL HOME LOAN POOL E00659	6.000	04/01/14	2,410,541	2,408,865	2,520,804	0.19%
FNMA POOL 190985	7.500	08/01/09	963,936	963,922	1,031,675	0.08%
FNMA POOL 254140	5.500	01/01/17	12,071,064	12,025,785	12,388,402	0.92%
FNMA POOL 254233	5.000	03/01/17	8,473,828	8,211,424	8,518,514	0.64%
FNMA POOL 254631	5.000	02/01/18	6,902,863	6,993,043	6,934,304	0.52%
FNMA POOL 303590	7.000	11/01/10	1,174,205	1,174,205	1,251,675	0.09%
FNMA POOL 313999	6.000	02/01/13	1,274,260	1,268,793	1,333,742	0.10%
FNMA POOL 572220	6.000	03/01/16	830,185	828,060	866,344	0.06%
FNMA POOL 592327	5.500	06/01/16	1,494,873	1,463,583	1,536,040	0.11%
GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	VAR	04/16/20	15,636,229	15,585,949	15,125,886	1.13%

<u>Security Name</u>	<u>Coupon</u>	<u>Maturity</u>	<u>Par</u>	<u>Book Value</u>	<u>Fair Value</u>	<u>% of Total</u>
<b>GOVERNMENT-MORTGAGE BACKED</b>			<b>58,010,579</b>	<b>57,688,739</b>	<b>58,528,244</b>	<b>4.36%</b>
HOUSEHOLD FINANCE CORP	6.875	03/01/07	3,000,000	2,972,119	3,244,281	0.24%
HOUSEHOLD FINANCE CORP	4.750	05/15/09	1,000,000	999,157	1,006,708	0.08%
IBP FINANCIAL CO	7.450	06/01/07	4,000,000	3,999,195	4,283,080	0.32%
PANAMERICAN BEVERAGES INC	7.250	07/01/09	2,000,000	1,969,662	2,180,000	0.16%
<b>YANKEE BONDS</b>			<b>10,000,000</b>	<b>9,940,133</b>	<b>10,714,069</b>	<b>0.80%</b>
BGI S & P 500 INDEX FUND B	NA	NA	480,587	68,406,676	72,138,374	5.38%
<b>EQUITY INDEX FUND</b>			<b>480,587</b>	<b>68,406,676</b>	<b>72,138,374</b>	<b>5.38%</b>
MONOGENESIS CORP	NA	NA	1	0	0	0.00%
OCEAN WEST HOLDING CORP	NA	NA	100	15	23	0.00%
<b>EQUITY OTHER</b>			<b>101</b>	<b>15</b>	<b>23</b>	<b>0.00%</b>
CALIFORNIA STREET, HELENA, MONTANA	NA	NA	204,835	204,835	207,667	0.02%
2401 COLONIAL DRIVE, HELENA, MONTANA	NA	NA	7,041,755	7,041,755	7,581,000	0.57%
1712 NINTH AVENUE, HELENA, MONTANA	NA	NA	498,712	498,712	576,369	0.04%
100 NORTH PARK AVENUE, HELENA, MONTANA	NA	NA	6,284,034	6,284,034	5,795,000	0.43%
2273 BOOT HILL COURT, BOZEMAN, MONTANA	NA	NA	2,063,604	2,063,604	2,082,014	0.16%
<b>EQUITY REAL ESTATE</b>			<b>16,092,940</b>	<b>16,092,940</b>	<b>16,242,050</b>	<b>1.21%</b>
MONTANA RESIDENTIAL MORTGAGES	NA	NA	119,513,572	119,513,572	119,542,865	8.91%
MONTANA MULTI FAMILY/COMMERCIAL LOANS	NA	NA	4,105,800	4,105,800	4,078,000	0.30%
MONTANA PERMANENT COAL TAX TRUST LOANS	NA	NA	221,861,642	221,861,642	221,861,642	16.54%
<b>MORTGAGES/LOANS</b>			<b>345,481,014</b>	<b>345,481,014</b>	<b>345,482,507</b>	<b>25.76%</b>
USB MUNICIPAL INVESTOR ACCOUNT	1.250	NA	37,847,576	37,847,576	37,847,576	2.82%
<b>CASH EQUIVALENTS</b>			<b>37,847,576</b>	<b>37,847,576</b>	<b>37,847,576</b>	<b>2.82%</b>
<b>TOTAL ALL OTHER FUNDS</b>			<b>1,262,147,263</b>	<b>1,324,087,590</b>	<b>1,341,236,868</b>	<b>100.00%</b>

## LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

### INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statement of Net Assets of the Enterprise Fund of the state of Montana Board of Investments as of June 30, 2004, and 2003, and the related Statement of Revenues, Expenses, and Changes in Fund Net Assets and Statement of Cash Flows for the fiscal years then ended. These financial statements are the responsibility of the Board of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the Enterprise Fund of the Montana Board of Investments and are not intended to present fairly the financial position of the state of Montana as of June 30, 2004, and 2003, and the results of the operations and cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the state of Montana Board of Investments' Enterprise Fund as of June 30, 2004, and 2003, and the results of its operations and cash flows of its Enterprise Fund for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*(Signature on File)*

James Gillett, CPA  
Deputy Legislative Auditor

November 15, 2004

**B-68**

**STATE OF MONTANA BOARD OF INVESTMENTS ENTERPRISE FUND  
STATEMENT OF NET ASSETS AS OF JUNE 30, 2004 AND 2003**

**Assets**

	<u>2004</u>	<u>2003</u>
<b>Current assets:</b>		
Cash and cash equivalents (Notes 1 and 9)	\$ 7,534,708	\$ 10,817,077
Interest receivable (Note 9)	735,782	900,532
Notes/loans receivable (Notes 1 and 9)	9,176,128	11,067,695
Interfund notes/loans receivable (Notes 1 and 9)	3,141,523	2,485,075
Component Unit notes/loans receivable (Notes 1 and 9)	1,195,650	1,284,431
Short-term investments (Note 2)	23,243,262	8,954,343
Prepaid expenses	<u>18</u>	<u>36</u>
<b>Total current assets (Note 9)</b>	<b><u>45,027,071</u></b>	<b><u>35,509,189</u></b>
<b>Noncurrent assets:</b>		
Restricted Investments (Note 2)	4,394,269	3,496,317
Notes/loans receivable (Notes 1 and 9)	36,174,241	36,520,323
Interfund notes/loans receivable (Notes 1 and 9)	9,181,931	5,822,017
Component Unit notes/loans receivable (Notes 1 and 9)	6,262,003	4,687,291
Investments (Note 2)	236,974	175,000
Capitalized cost of issue (Note 1)	1,506,489	1,220,532
Equipment	12,240	12,239
Accumulated depreciation	<u>(8,078)</u>	<u>(6,120)</u>
<b>Total noncurrent assets ( Note 9)</b>	<b><u>57,760,069</u></b>	<b><u>51,927,599</u></b>
<b>Total assets</b>	<b>\$ <u>102,787,140</u></b>	<b>\$ <u>87,436,788</u></b>
<b>Liabilities</b>		
<b>Current liabilities:</b>		
Advances	\$ 98,687	\$ 101,272
Due to other funds	6,084	7,259
Accrued expenses	14,694	11,018
Accrued interest payable	612,771	649,706
Deferred cost of issue recovery	17,785	17,785
Arbitrage rebate tax payable	83,819	73,344
Compensated absences	11,343	12,040
Current bonds/notes payable (Note 4)	<u>92,227,028</u>	<u>74,266,636</u>
<b>Total current liabilities</b>	<b><u>93,072,211</u></b>	<b><u>75,139,060</u></b>
<b>Noncurrent liabilities</b>		
Bonds/notes payable (Note 4 )	4,615,051	7,188,600
Compensated absences	13,609	18,929
Deferred cost of issue recovery	0	17,785
Arbitrage rebate tax payable	<u>55,716</u>	<u>97,294</u>
<b>Total noncurrent liabilities</b>	<b><u>4,684,376</u></b>	<b><u>7,322,608</u></b>
<b>Total liabilities</b>	<b>\$ <u>97,756,587</u></b>	<b>\$ <u>82,461,668</u></b>
<b>Net Assets</b>		
Invested in capital assets, net of related debt	\$ 4,162	\$ 6,119
Restricted (Note 1)	2,763,134	2,852,753
Unrestricted	<u>2,263,257</u>	<u>2,116,248</u>
<b>Total net assets (Note 8)</b>	<b>\$ <u>5,030,553</u></b>	<b>\$ <u>4,975,120</u></b>
<b>Total liabilities and net assets</b>	<b>\$ <u>102,787,140</u></b>	<b>\$ <u>87,436,788</u></b>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS ENTERPRISE FUND  
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND 2003**

<b>Operating revenue</b>	<b><u>2004</u></b>	<b><u>2003</u></b>
Reimbursements	\$ 7,939	\$ 20,403
Investment income	82,642	339,106
Security lending income	0	0
Financing income	<u>2,161,416</u>	<u>2,595,717</u>
<b>Total operating revenue</b>	<b><u>2,251,997</u></b>	<b><u>2,955,226</u></b>
<b>Operating expenses</b>		
Personal services	186,075	198,973
Contracted services	33,431	38,174
Supplies and materials	6,602	4,382
Communications	6,344	7,051
Travel	3,988	3,906
Rent	39,231	38,749
Repair and maintenance	655	499
Indirect and other costs	26,591	35,662
Depreciation expense	1,958	1,958
Arbitrage rebate tax expense	40,127	81,862
Security lending expense	0	0
Debt service		
Interest expense	1,519,894	1,675,336
Trustee fee expense	49,849	40,541
Bond issuance cost amortization expense	131,473	142,349
Other debt service expense	150,346	156,915
<b>Total operating expenses</b>	<b><u>2,196,564</u></b>	<b><u>2,426,357</u></b>
<b>Operating income</b>	<b><u>55,433</u></b>	<b><u>528,869</u></b>
<b>Nonoperating (expense):</b>		
Transfers out (Note 6)	<u>0</u>	<u>(297,266)</u>
<b>Change in net assets</b>	<b>55,433</b>	<b>231,603</b>
Beginning net assets	<u>4,975,120</u>	<u>4,743,517</u>
Ending net assets (Note 8)	\$ <u>5,030,553</u>	\$ <u>4,975,120</u>

The accompanying notes are an integral part of these financial statements.

**STATE OF MONTANA BOARD OF INVESTMENTS ENTERPRISE FUND  
STATEMENT OF CASH FLOWS FOR THE YEARS ENDED JUNE 30, 2004 AND 2003**

	<u>2004</u>	<u>2003</u>
<b>Cash flows from operating activities:</b>		
Receipts for sales and services	\$ 7,939	\$ 20,403
Payments to suppliers for goods and services	(117,308)	(126,042)
Payments to employees	<u>(188,127)</u>	<u>(193,186)</u>
<b>Net cash (used for) operating activities</b>	<u>(297,496)</u>	<u>(298,825)</u>
<b>Cash flows from non-capital financing activities:</b>		
Payment of principal and interest on bonds and notes	(4,987,227)	(5,128,094)
Proceeds from issuance of bonds and notes	18,600,621	15,476,643
Payment of bond issue costs	(401,007)	(335,330)
Transfers to other funds (Note 6)	<u>0</u>	<u>(297,266)</u>
<b>Net cash provided by non-capital financing activities</b>	<u>13,212,387</u>	<u>9,715,953</u>
<b>Cash flows from capital and related financing activities:</b>		
Acquisition of fixed assets	<u>0</u>	<u>0</u>
<b>Net cash (used for) capital and related financing activities</b>	<u>0</u>	<u>0</u>
<b>Cash flows from investing activities:</b>		
Collections for principal and interest on loans	28,978,347	25,059,876
Cash payments for loans	(29,923,593)	(24,688,342)
Purchase of investments	(28,131,728)	(11,979,150)
Proceeds from security lending	0	0
Security lending costs	0	0
Proceeds from sales or maturities of investments	12,577,928	4,914,061
Interest on investments	373,014	366,287
Payments for arbitrage rebate tax	<u>(71,229)</u>	<u>(83,279)</u>
<b>Net cash (used for) investing activities</b>	<u>(16,197,261)</u>	<u>(6,410,547)</u>
Net increase (decrease) in cash and cash equivalents	(3,282,369)	3,006,581
Cash and cash equivalents, July 1	<u>10,817,077</u>	<u>7,810,496</u>
Cash and cash equivalents, June 30	<u>7,534,708</u>	<u>10,817,077</u>
<b>Reconciliation of net income to net cash (used for) operating activities:</b>		
Net income	55,433	528,869
Adjustments to reconcile net income to net cash (used for) operating activities		
Depreciation	1,958	1,958
Interest on investments	(82,642)	(339,106)
Financing income	(2,161,416)	(2,595,717)
Interest expense	1,851,563	2,015,141
Security lending income	0	0
Security lending expense	0	0
Arbitrage rebate tax expense	40,127	81,862
Change in assets and liabilities:		
Increase/decrease in due from other funds	0	(179)
Increase/decrease in other assets	18	38
Increase/decrease in other payables	3,676	8,741
Increase/decrease in due to other funds	(196)	2,421
Increase/decrease in compensated absences payable	<u>(6,017)</u>	<u>(2,853)</u>
<b>Total adjustments</b>	<u>(352,929)</u>	<u>(827,694)</u>
<b>Net cash (used for) operating activities</b>	\$ <u>(297,496)</u>	\$ <u>(298,825)</u>
<b>Schedule of noncash transactions:</b>		
Increase/decrease in fair value of investments	\$ <u>(234,794)</u>	\$ <u>1,303</u>
<b>Total noncash transactions</b>	\$ <u>(234,794)</u>	\$ <u>1,303</u>

The accompanying notes are an integral part of these financial statements.



**STATE OF MONTANA BOARD OF INVESTMENTS ENTERPRISE FUND**

**NOTES TO FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED JUNE 30, 2004 AND JUNE 30, 2003**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**a. Basis of Accounting**

The Board uses the accrual basis of accounting for the Enterprise Fund. Under the accrual basis of accounting, expenses are recorded when incurred and revenues are recorded when earned. The financial statements are prepared from the Statewide Accounting, Budgeting, and Human Resource System (SABHRS) and information contained in the bond trustee statements. The statements include the financial activity administered by the Board in the Enterprise Fund.

**b. Presentation of Programs**

The Board uses the Enterprise Fund to account for its programs created under the Economic Development Bond Act and the Municipal Finance Consolidation Act.

Economic Development Bond Act programs include:

- The Industrial Development Bond Program (IDB) provides access to limited economic development projects through the issuance of conduit debt.
- The Conservation Reserve Enhancement Program (CRP), created in 1990 by issuing bonds, allows farmers to receive a lump sum payment by assigning their federal CRP contract to the Board. The farmers under contract must comply with seeding and other requirements. The Conservation Reserve Enhancement Program is funded by the Montana Trust Funds Bond Pool.
- The Family Friendly Business Loan Program provides zero interest loans to qualified business owners who hire participants of the Families Achieving Independence in Montana (FAIM) employment and training component.

Municipal Finance Consolidation Act programs include:

- The INTERCAP loan program provides funds to eligible Montana governments to finance capital expenditures for up to ten years.
- The Irrigation District Pooled Loan Program provided funds for the Board to purchase the refunding bonds from participating irrigation districts for the purpose of prepaying the U.S. Department of Interior, Bureau of Reclamation Projects Loans.
- The School District Pooled Refunding Program provided funds for the Board to purchase the general obligation refunding bonds of participating Montana School Districts.

**c. Fixed Asset Depreciation**

The equipment fixed assets recorded in the Enterprise Fund are depreciated on a straight-line basis, with salvage value, in accordance with state policy.

**d. Receivables**

The Enterprise Fund notes/loans receivables of \$64,962,608 as of June 30, 2004, and \$61,717,146, previously stated as \$61,771,266 as of June 30, 2003, represent loans made to Montana businesses, state and local governments. The Enterprise Fund notes/loans are classified in three categories as follows:

- 1) Notes/loans receivable from local governments and Montana businesses
- 2) Interfund notes/loans receivable from state agency governments
- 3) Component Unit notes/loans receivable from certain state agencies and university units for which the State is financially accountable.

As of June 30, 2004 and 2003, there were no uncollectible account balances. However, in November 2003, the Enterprise Fund wrote off a loan principal balance of \$10,791 for the Rosebud Food and Fuel loan. The Family Friendly Business Loan Program funded \$27,000 for this loan in June 1999.

The InterFund notes/loans receivable as of June 30, 2004 and 2003 includes \$168,868 and \$149,686, respectively, in interest accruals from state agencies and university units.

e. Capitalized Cost of Issue

The Enterprise Fund capitalized cost of issue asset of \$1,506,489 and \$1,220,532 as of June 30, 2004 and June 30, 2003, respectively, represents paid bond issuance costs which have been capitalized and are being amortized, using the straight-line method, over the life of the bond.

f. Cash and Cash Equivalents

For purposes of the Statement of Cash Flows, the Enterprise Fund considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents, as identified in the Statement of Net Assets, are as follows:

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Cash in Treasury	24,756	13,726
Cash with Fiscal Agent (Note 9)	2,490,280	2,297,689
Short Term Investment Pool (STIP)	186,263	142,680
First American treasury obligation class D corporate trust fund	<u>4,833,409</u>	<u>8,362,981</u>
	<u>7,534,708</u>	<u>10,817,077</u>

The Enterprise Fund invests its excess cash in the Board's Short Term Investment Pool, STIP, an external investment pool. An external investment pool commingles the moneys of more than one legally separate entity and invests, on the participants' behalf, in an investment portfolio. STIP participants include both state agencies and local governments. By meeting certain conditions, STIP, as a 2a7-like pool, is allowed to use amortized cost rather than fair value to report net assets to compute unit values.

g. Restricted Net Assets

The Statement of Net Assets for the Enterprise Fund reports restricted assets. Net assets are reported as restricted when constraints placed on net asset use are either:

- a. Externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments.
- b. Imposed by law through constitutional provisions or enabling legislation.

The net assets of all Enterprise Fund programs with the exception of MEDB (Montana Economic Development Bonds) Guarantee Fund Account, MEDB Guarantee CRP Note Reserve, MEDB Contingency Account, MEDB Family Friendly Account and CRP are restricted under bond indentures governing the use of these funds.

2. **INVESTMENTS**

The deposits and investments in the Enterprise Fund are restricted by the bond trust indentures to the following: government and agency obligations, certificates of deposits, repurchase agreements, and investment agreements. Deposits and investments must be made with Montana banks or in the Short Term Investment Pool (STIP) administered by the Board. The deposits and investments are combined on the Board's financial statements.

Investments are presented in the Statement of Net Assets at fair value. Investment fair values for publicly traded securities are determined primarily by reference to market prices supplied to the Board's trustee. Amortized cost, or carrying value, represents the original cost, adjusted for premium and discount amortization where applicable. Premiums and discounts are amortized/accreted using the straight-line method to the maturity date of the securities.

The Board's investments in the Enterprise Fund are classified on the next page as to credit risk by Category 1, which includes investments that are insured or registered, or securities held by the Board or its agent in the Board's name.

Risk as of June 30, 2004			
Long-Term Investments			
<u>Investment Type</u>	<u>Category 1</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Government Securities	\$ <u>4,661,802</u>	\$ <u>4,661,802</u>	\$ <u>4,631,243</u>
Total long-term investments	\$ <u>4,661,802</u>	\$ <u>4,661,802</u>	\$ <u>4,631,243</u>
Short-Term Investments			
Government Securities	\$ <u>23,254,675</u>	\$ <u>23,254,675</u>	\$ <u>23,243,262</u>
Total short-term investments	\$ <u>23,254,675</u>	\$ <u>23,254,675</u>	\$ <u>23,243,262</u>
Securites Lending Collateral Investment Pool	\$ <u>0</u>	\$ <u>0</u>	\$ <u>0</u>
Risk as of June 30, 2003			
Long-Term Investments			
<u>Investment Type</u>	<u>Category 1</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Government Securities	\$ <u>3,509,883</u>	\$ <u>3,509,883</u>	\$ <u>3,671,317</u>
Total long-term investments	\$ <u>3,509,883</u>	\$ <u>3,509,883</u>	\$ <u>3,671,317</u>
Short-Term Investments			
Government Securities	\$ <u>8,922,955</u>	\$ <u>8,922,955</u>	\$ <u>8,954,343</u>
Total short-term investments	\$ <u>8,922,955</u>	\$ <u>8,922,955</u>	\$ <u>8,954,343</u>
Securites Lending Collateral Investment Pool	\$ <u>0</u>	\$ <u>0</u>	\$ <u>0</u>

There were no derivative transactions during the above fiscal years for investments held by the trustee.

### 3. SECURITY LENDING

The Enterprise Fund is a participant in the Board's Short Term Investment Pool (STIP).

Under the provisions of state statutes, the Board has, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the Board's STIP securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the Board receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 2004 and 2003, State Street loaned, on behalf of the Board, certain STIP securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit as collateral. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2004 and 2003 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2004 and 2003. Moreover, there were no losses during fiscal years 2004 and 2003 resulting from a default of the borrowers or State Street.

During fiscal years 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine.

#### 4. BONDS PAYABLE

##### Long-Term Bonds Payable

##### Economic Development Bonds (EDB) and Municipal Finance Consolidation Act Bonds (MFCAB)

These bonds are issued under the Economic Development Bond Act, and the Municipal Finance Consolidation Act, for the purpose of assisting Montana's small businesses and local governments in obtaining low cost financing. Outstanding obligations are listed as follows (in thousands):

##### Bonds Payable as of June 30, 2004

<u>Program</u>	<u>Series</u>	<u>Amount Issued</u>	<u>Interest Range %</u>	<u>Principal Payments FY 2005</u>	<u>@ Maturity</u>	<u>Balance June 30, 2004</u>
Municipal Finance Consolidation Act Bonds (Irrigation Program) (1)	1988	4,976	6.60-7.75	325	130 (2014)	1,205
Municipal Finance Consolidation Act Bonds (School District Pooled Refunding Program) (3)	1991	6,234	4.75-6.50	294	294 (2005)	294
Conservation Reserve Enhancement Program (CRP Bonds) (2)		<u>4,789</u>	<u>6.00-8.00</u>	<u>1,053</u>	<u>377 (2009)</u>	<u>4,789</u>
Total Bonds Payable		<u>\$ 15,999</u>		<u>\$ 1,672</u>		<u>\$ 6,288</u>
Less Current Portion (FY2004 Principal Payments)						<u>(1,672)</u>
Total Long-Term Bonds Payable						<u>\$ 4,616</u>

##### Bonds Payable as of June 30, 2003

<u>Program</u>	<u>Series</u>	<u>Amount Issued</u>	<u>Interest Range %</u>	<u>Principal Payments FY 2004</u>	<u>@ Maturity</u>	<u>Balance June 30, 2003</u>
Municipal Finance Consolidation Act Bonds (Irrigation ) Program (1)	1988	4,976	6.60-7.75	520	130 (2014)	1,707
Municipal Finance Consolidation Act Bonds (School District Pooled Refunding Program) (3)	1991	6,234	4.75-6.50	287	294 (2005)	581
Conservation Reserve Enhancement Program (CRP Bonds) (2)		<u>6,977</u>	<u>6.00-8.00</u>	<u>1,270</u>	<u>30 (2011)</u>	<u>6,977</u>
Total Bonds Payable		<u>\$ 18,187</u>		<u>\$ 2,077</u>		<u>\$ 9,265</u>
Less Current Portion (FY2003 Principal Payments)						<u>(2,077)</u>
Total Long-Term Bonds Payable						<u>\$ 7,188</u>

(1) The Board issued these bonds to provide funds to purchase the Refunding Bonds of participating Irrigation Districts for the purpose of prepaying the U.S. Department of Interior, Bureau of Reclamation Projects Loans. The Irrigation Bonds and the interest thereon are payable solely from the collection of a special tax or assessment which is a lien against real property in the Irrigation District. While the Irrigation Bonds are not obligations of the State of Montana, the bonds are limited obligations of the Board due to an irrevocable pledge to lend money for deposit by the Trustee of the Irrigation District Pooled Loan Program Reserve Account E in an amount equal to any deficiencies therein on any payment date. The Indenture does not permit the issuance of additional bonds.

(2) The Conservation Reserve Enhancement Program is funded by the Montana Trust Funds Bond Pool.

(3) The Board issued these bonds to provide funds to purchase the general obligation refunding bonds of participating Montana School Districts. The School District Refunding Bonds and the interest thereon are payable from real property taxes levied within the school district. The 1991 Bonds are limited obligations of the Board, and are not a debt or liability of the State of Montana, and neither the faith and credit nor the taxing power of the state is pledged to the payment of principal of or interest on the bonds.

Future debt service (principal and interest) as of June 30, 2004 is listed below (in thousands):

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010+</u>	<u>Total</u>
\$	2,109	\$ 1,542	\$ 1,410	\$ 1,391	\$ 536	\$ 675	\$ 7,663

Future debt service (principal and interest) as of June 30, 2003 is listed below (in thousands):

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009+</u>	<u>Total</u>
\$	2,680	\$ 2,352	\$ 1,785	\$ 1,648	\$ 1,629	\$ 1,544	\$ 11,638

#### Current Bonds Payable

The Enterprise Fund is authorized to issue INTERCAP bonds under the Municipal Finance Consolidation Act. These bonds may not aggregate more than \$120 million as amended by the 2003 Legislature. Previously, INTERCAP bonds may not aggregate more than \$80 million through June 30, 2011 and then \$75 million thereafter. The INTERCAP bonds provide funds for the Board to make loans to eligible government units. The bonds are not a debt or liability of the State of Montana. The bonds are limited obligations of the Board payable solely from: a) repayments of principal and interest on loans made by the Board to participating eligible Montana governments; b) investment income under the indenture; and c) an irrevocable pledge by the Board. The Board has no taxing power. These bonds may be redeemed, at the bondholder's option, any March 1, prior to maturity. The Board did not enter into an arms-length financing agreement to convert the bonds "put", but not resold into some other form of long-term obligation. Accordingly, these bonds, considered demand bonds, are recorded as current liabilities of the Enterprise Fund.

The INTERCAP obligations at June 30, 2004 and June 30, 2003, are listed below (in thousands):

<u>Series</u>	<u>Amount Issued</u>	<u>Interest Range</u>	<u>Maturity</u>	<u>Balance June 30, 2004</u>	<u>Balance June 30, 2003</u>
1992	6,500	Variable	2005	6,055	6,075
1994	7,500	Variable	2009	6,895	6,975
1995	7,500	Variable	2010	7,080	7,115
1997	10,000	Variable	2017	9,740	9,740
1998	12,500	Variable	2018	12,285	12,285
2000	15,000	Variable	2025	15,000	15,000
2003	15,000	Variable	2028	15,000	15,000
2004	<u>\$18,500</u>	Variable	2029	<u>18,500</u>	<u>0</u>
<b>Total INTERCAP Debt</b>	<b><u>\$92,500</u></b>			<b><u>90,555</u></b>	<b><u>72,190</u></b>
<b>Current Portion of Long-Term Bonds Payable</b>				<b><u>1,672</u></b>	<b><u>2,077</u></b>
				<b><u>92,227</u></b>	<b><u>74,267</u></b>

## 5. OTHER DEBT

### Conduit Debt

In this program, the Board is authorized to issue stand-alone industrial revenue bonds, under the Economic Development Act, as conduit (no commitment) debt. Assets and revenues of the borrower are pledged to repay the bonds. Because the Board has no obligation for this debt, these bond issues are not reflected on the Board's financial statements. Bonds issued by the Board as conduit (no-commitment) debt are listed below (in thousands):

#### Conduit Debt

<u>Project</u>	<u>Issue Date</u>	<u>Maturity Date</u>	<u>Amount Issued</u>	<u>Balance June 30, 2004</u>	<u>Balance June 30, 2003</u>
MT Cenex (Farmers Union)	August 1985	09/01/10	\$ 3,925	0	3,925
Colstrip	October 1989	12/30/15	60,800	55,300	57,300
Yellowstone Energy (BGI)	July 1993	12/31/19	118,345	116,945	117,345
Stillwater Mining	July 2000	07/01/20	30,000	30,000	30,000
Gainey Foundation	October 2002	09/01/14	<u>6,000</u>	<u>5,570</u>	<u>6,000</u>
Total conduit debt			<u>\$ 219,070</u>	<u>\$ 207,815</u>	<u>\$ 214,570</u>

In this program, the Board is authorized to issue Qualified Zone Academy Bonds (QZAB), under the Municipal Finance Consolidation Act, as conduit (no commitment) debt. The revenues, and in some cases the taxing power, of the borrower are pledged to repay the bonds. Because the Board has no obligation for this debt, these bond issues are not reflected on the Board's financial statements. Bonds issued by the Board as conduit (no-commitment) debt are listed below (in thousands):

#### QZAB Debt

<u>Project</u>	<u>Issue Date</u>	<u>Maturity Date</u>	<u>Amount Issued</u>	<u>Balance June 30, 2004</u>	<u>Balance June 30, 2003</u>
Huntley Project K-12 Schools	December 2000	07/01/13	\$ 750	\$ 750	\$ 750
Bozeman Public Schools	November 2003	11/25/12	1,586	1,586	0
Philipsburg Schools	December 2003	12/10/17	<u>2,000</u>	<u>2,000</u>	<u>0</u>
Total conduit debt			<u>\$ 4,336</u>	<u>\$ 4,336</u>	<u>\$ 750</u>

## 6. TRANSFERS OUT

In fiscal year 2003, the Enterprise Fund transferred \$297,266 to the Board of Investment's Investment account. No transfers were made to the Board of Investment's Investment account in fiscal year 2004.

## 7. INTERCAP PROGRAM LOAN COMMITMENTS

The Board makes firm commitments to fund loans from the INTERCAP loan program. As of June 30, 2004 and 2003, respectively, the Board committed to make loans to eligible Montana governments totaling \$37,068,745 and \$20,170,082.

## 8. NET ASSETS

Net Assets represents the accumulated net profits of the Enterprise Fund programs. The Net Assets for fiscal years ended June 30, 2004 and June 30, 2003 include (\$41,971) and \$192,823, respectively, in unrealized appreciation/depreciation in reporting the fair value of the Enterprise Fund investments.

## 9. RESTATEMENT

The Board implemented the provisions of the state's Management Memo 02-04-12 Accounting for INTERCAP Loans Provided to State Agencies (Including Higher Education Units) effective July 1, 2003. In implementing this Management Memo, the Notes/Loans Receivable as of June 30, 2003 were reclassified to reflect current year payments rather than note maturities. The financial statements for the year ended June 30, 2003 have been restated, for these changes, to compare with the financial statements for the year ended June 30, 2004. These restatements are described in the following paragraphs.

In the Statement of Net Assets as of June 30, 2003, the Cash and Cash Equivalents has been restated to reflect a change in Cash with Fiscal Agent. Cash with Fiscal Agent, previously reported as \$2,243,569, is now presented as \$2,297,689 to reflect a loan principal payment of \$54,120 received as of June 30, 2003. The Cash with Fiscal Agent change results in the total Cash and Cash Equivalents, as of June 30, 2003, being restated as \$10,817,077 from \$10,762,957. The Interest Receivable of

**\$900,532 reflects the reclassification of loan interest due from state agencies and university units. Interest Receivable was previously reported as \$1,050,039. The Current Assets for Notes/loans Receivable of \$6,356,754 and Due From Other Funds of \$179 has been restated as Notes/loans Receivable of \$11,067,695 due from local governments and Montana businesses, Interfund Notes/loans Receivable of \$2,485,075 due from state agencies and Component Unit Notes/Loans Receivable of \$1,284,431 due from certain state agencies and university units. The Total Current Assets amount of \$27,124,308, as previously reported, has been changed to \$35,509,189 to address the above changes. The Noncurrent Assets Restricted for Notes/loans Receivable of \$47,751,994 has been restated as Interfund Notes/loans Receivable of \$5,822,017 due from state agencies and Component Unit Notes/Loans Receivable of \$4,687,291 due from certain state agencies and university units. The balance of the Noncurrent Assets Restricted for Notes/loans Receivable totaling \$28,857,805 due from local governments and Montana businesses was combined with the previously reported Notes/Loans Receivable amount of \$7,662,518 for a restated Notes/Loans Receivable total of \$36,520,323. The Total Assets Restricted amount of \$51,248,311 as previously reported, has been changed to \$3,496,317 to address the above changes.**

**In the Statement of Cash Flows for the Year Ended of June 30, 2003, Cash Flows from Investing Activities section, the Collections for Principal and Interest on Loans has been restated as \$25,059,876 from \$25,005,756 as previously reported to reflect a loan principal payment of \$54,120 received as of June 30, 2003. This change results in the Net Cash (Used For) Investing Activities being reported as \$(6,410,547) from \$(6,464,667). The Net Increase (Decrease) in Cash and Cash Equivalents changed to \$3,006,581 from \$2,952,461 and Cash and Cash Equivalents, as of June 30, 2003, are restated as \$10,817,077 from \$10,762,957 as previously reported.**

## **Board Response**

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# MONTANA BOARD OF INVESTMENTS

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December 7, 2004

Scott A. Seacat, Legislative Auditor  
Legislative Audit Division  
Room 135, State Capitol  
Helena MT 59620-1705

RECEIVED  
DEC 08 2004  
LEGISLATIVE AUDIT DIV.

Dear Scott:

We appreciate the services your staff provide to the Board of Investments in reviewing our procedures, internal controls, accounting practices, and the accuracy of our financial statements. The Board invests \$9.6 billion of public funds and during the past fiscal year handled investments for 473 state and local government accounts. Our complex operation utilizes five different accounting systems to accurately track investments in various asset classes.

Our responses to your recommendations follow:

## **Recommendation #1**

A. Publish our annual report by December 31, as required by state law:

*We concur.* We reformatted our Fiscal 2003 annual report to facilitate its posting on our web site and will publish our Fiscal 2004 report in PDF format on our site by December 31, 2004.

B. Provide timely draft financial statements to the Department of Administration as required by state policy.

*We concur.* We will complete all eight draft financial statements by September 30, 2005.

C. Consider adopting private sector financial industry standards for the completion and release of the annual audited financial statements.

*We do not concur.* The Board is a state agency delegated by state law to invest all public funds. We believe that governmental accounting standards should apply to our operations rather than standards imposed on private sector investment companies. Because all Board clients are governmental agencies they too are subject to governmental accounting standards.

## **Recommendation #2**

Review the Board's participation in issuing rural and special improvement district bonds and provide the report required by state law to the next legislature.

*We concur.* Although we diligently track all legislation impacting or referencing the Board, this legislation passed under our radar and we were totally unaware of this provision. We will prepare the report and submit it to the 2005 Legislature.

**Disclosure Issue** - The Legislature and Board of Investments should reconsider the appropriate use of the INTERCAP program loans.

Some of these recent INTERCAP loans should be considered state debt because the source of repayment is revenue derived from the state's taxing power.

*Agency Response.* This issue is very serious and should be addressed by the administration and the legislature to maintain the integrity of the INTERCAP program. Although, the Board administers the INTERCAP program it has not promoted the use of the program by state agencies. The program was created in the early 1980's as a low interest loan program specifically for local governments. However, the legislature has increasingly used the program as a convenient way for state agencies to access low interest loans. In the early 1990's the legislature authorized the university system to borrow from the program and later in the decade authorized selected state agencies to borrow as well. During the 2001 and 2003 sessions, the legislature greatly increased the use of the program at the request of executive branch agencies.

While the Board loans state funds (Coal Tax Trust) to Montana businesses as a part of the in-state investment program, the INTERCAP program is funded entirely by private investors. The Board borrows the funds via the issuance of tax-exempt bonds that are remarketed annually in March. These bonds have always been popular with investors and we have always found ready buyers for the entire bond portfolio. However, any cloud of doubt hanging over the underlying loans funded by these bonds could have a detrimental effect upon the Board's ability to remarket \$84.3 million in INTERCAP bonds in March 2005. If this issue is not resolved, rating agencies could lower the rating on the bonds, resulting in a higher interest rate that will be passed on to state and local government borrowers.

We suggest a two-part solution to the problem. The first part is critical to the integrity of the program and should be a priority for the 2005 Legislature. To remove any cloud of doubt regarding current state agency INTERCAP loans authorized by the legislature that could be considered state debt, the loans should be reauthorized in one bill specifying that the loans are state debt. The timely passage of this legislation by a two thirds vote of both houses will eliminate or at least reduce problems the Board may otherwise encounter remarketing the bonds in March 2005.

This legislation would "grandfather" current state agency INTERCAP loans while permitting the legislature to consider via other legislation the future use of the program by state agencies. There may be instances such as the state motor pool where there is no other viable funding source for the maintenance of the pool fleet. Also, the university system has regularly used the program for many years and may have difficulty finding other sources of borrowed funds.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Carroll South", with a large, sweeping loop at the end.

Mr. Carroll South, Executive Director  
Montana Board of Investments